Petition

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81-1804

No. .....

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

RCA CORPORATION,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Questions Presented for Review

1. Did the court of appeals err in holding that the Commissioner of Internal Revenue was entitled to reject a method of accounting which the district court had found clearly reflected income and in further holding that the district court was barred from even making that finding?

2. Did the court of appeals err in ruling that regulations promulgated under Section 381(c)(4) of the Code, despite their plain language, do not apply to RCA Corporation, when its holding was predicated on its mistaken belief that these regulations are applicable only to instances in which different accounting methods were used, while, in fact, the regulations explicitly apply both when the same and different methods are used?

3. Did the court of appeals err in refusing to apply a revenue ruling retroactively, predicated on the assumption that RCA had not applied to use the accounting method set forth therein, while, in fact, (a) such application is not required and (b) the assumption is contrary to the stipulation of the parties?

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner RCA Corporation ("RCA") respectfully prays that a writ of *certiorari* issue to review the opinion and judgment of the United States Court of Appeals for the Second Circuit entered in this proceeding on November 13, 1981 and its order entered on December 30, 1981.

Opinions Below

The opinion of the court of appeals, reported at 664 F.2d 881, and the judgment and the order denying RCA's petition for rehearing *en banc* appear in the Appendix hereto. The opinion of the District Court for the Southern District of New York, reported at 499 F. Supp. 507, and the judgment of the district court, appear in the Appendix hereto.[1]

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[1] Citation to the appendix is "—a". In response to Rule 28.1 of the Rules of this Court, Petitioner states that it has no parent companies and no subsidiaries other than wholly-owned subsidiaries.

Jurisdiction

The judgment of the Court of Appeals for the Second Circuit was entered on November 13, 1981 (24a). A timely petition for rehearing *en banc* was denied on December 30, 1981, and this petition for *certiorari* was filed within 90 days of that date (1a). This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1) (1976).

Statutory Provisions Involved

Sections 381 and 446 of the Internal Revenue Code of 1954, as amended (the "Code"), Treas.Reg. § 1.381(c)(4)-1, Revenue Ruling 71-299, 1971-2 C.B. 218 and Revenue Procedure 71-21, 1971-2 C.B. 549 appear in the Appendix hereto (66a-111a).

Statement of the Case

This is a tax refund action brought in the United States District Court for the Southern District of New York under 28 U.S.C. § 1346(a)(1) (1976), in respect of RCA's tax years 1958 and 1959, and involves a determination of the year in which certain receipts must be included in income. RCA Service Company ("RCAS") used the cash method of accounting for unearned receipts attributable to prepayments on service contracts for television repairs. RCAS was liquidated into RCA on December 31, 1957. Thereafter, RCA continued RCAS's business through its Service Company division (5a). RCA, an accrual basis taxpayer at the time of the liquidation, adopted the accrual method for reporting these unearned receipts (5a).

Purchasers of RCA's television repair services would, upon execution of a service contract, prepay a specified amount in exchange for RCA's agreement to provide repair

services for television sets for a contractually specified period of time (generally, between three and 24 months) (29a).

RCA accounted for these unearned receipts as income at the time they were earned through performance of the related service, rather than at the time of receipt. This was done in order to include service contract revenues in income at rates which would match the related expenses as they were incurred.[2] RCA achieved this matching by means of a sophisticated and comprehensive statistical system prepared in advance for each year. The system was designed to reflect seasonal patterns, historical variations in daily workload and calendar factors such as the number of workdays in a particular month. As a result, the rates at which balances would be taken in income would vary from month to month and would differ from the rates to be used for the identical contract sold in the following month. During the course of the trial before the district court, the Internal Revenue Service ("IRS") stipulated that RCA's accounting method "does accomplish its objective" which was to match service contract revenues with related expenses (58a).

Upon audit, the IRS had rejected RCA's accounting method as not clearly reflecting income. It required RCA to recognize contract prepayments as income at the time of receipt, rather than as earned. This resulted in a hybrid method of accounting (*viz.*, cash method for unearned service receipts and accrual method for all other income and expense) which, as demonstrated by expert testimony at trial, "distorts income very seriously." The IRS also con-

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[2] As was observed by this Court in *United States* v. *Anderson*, 269 U.S. 422, 440 (1926), the matching of income with expenses attributable to the generation of that income is the fundamental operating principle of the accrual method of accounting.

tended that RCA was required by Section 381 to continue the cash method of accounting used by RCAS for unearned prepayments.

The district court, per Morris E. Lasker, J., rejected the IRS's arguments, holding that: (i) RCA's accounting method "achieved its objective of matching revenues and related expenses with precision" (54a) and clearly reflected RCA's income under Section 446 of the Code and, therefore, the Commissioner of Internal Revenue (the "Commissioner") abused his discretion in compelling RCA to use the cash method (60a, 64a-65a),[3] and (ii) the "special" or transitional rules in Treas.Reg. § 1.381(c)(4)-1(e) expressly permitted RCA to adopt at the time of the liquidation of RCAS in 1957 the accrual method of accounting for reporting unearned service receipts (64a-65a). Judgment was entered for RCA in the amount of $6,460,482.93 for 1958 and $1,351,209.56 for 1959, plus statutory interest, for a total in excess of $15 million (26a-27a).

On November 13, 1981, a panel of the United States Court of Appeals for the Second Circuit rendered an opinion reversing the district court's decision in favor of RCA. The court neither questioned nor disturbed the district court's finding that RCA's method of accounting clearly reflected income as required by Section 446 of the Code. Instead the court ruled, relying on the decision of this Court in *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979) *("Thor")*, that the district court had misperceived its function in reviewing the IRS's determination to require RCA to include prepayments in income when received rather than earned. According to the court of appeals, the trial court's task was not to determine whether RCA's

[3] RCA did not argue and the district court did not find that RCA's accounting method should be sustained merely because it conformed to generally accepted accounting principles.

method of accounting for unearned service contract receipts clearly reflected income but to determine whether there was any legal basis to support the IRS's conclusion that it did not (13a). The court of appeals reviewed the so-called trilogy of decisions by this Court[4]—which the district court had distinguished on the basis of its factual findings about RCA's method of accounting—and determined that those decisions reflected "policies" (16a-17a) which required that the district court uphold the IRS's exercise of discretion in rejecting RCA's method of accounting without regard to whether or not RCA's accounting method actually did reflect its income clearly.

Further, the court of appeals ruled that Treas.Reg. § 1.381(c)(4)-1(e) did not apply to RCA since all regulations promulgated under Section 381(c)(4) of the Code were limited to situations in which the parties to the covered transaction used different methods of accounting. Since these regulations were in their entirety inapplicable to RCA, the court of appeals reasoned, they could not be asserted by RCA as a basis for it to use the accounting method for tax purposes which it used for all other purposes (22a-23a).

Finally, the court of appeals refused to apply Revenue Ruling 71-299 and Revenue Procedure 71-21 to RCA retroactively as required by Section 7805(b) of the Code and Treas.Reg. § 601.601(d)(2)(v)(*c*), because RCA purportedly did not seek to obtain the IRS's consent (23a).

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[4] *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180 (1957) (*"Michigan"*); *American Automobile Ass'n* v. *United States*, 367 U.S. 687 (1961) (*"AAA"*); *Schlude* v. *Commissioner*, 372 U.S. 128 (1963) (*"Schlude"*).

REASONS FOR GRANTING THE WRIT

1. The Absolute Discretion Conferred upon the IRS by the Court of Appeals and the Standard of Judicial Review of IRS Action Are in Conflict with the Decisions of other Appellate Courts and Raise Significant and Recurring Problems Concerning the Extent of the Discretion of the Commissioner.

The district court, after review of the relevant facts and after hearing expert testimony at trial, held that RCA's method of accounting for unearned receipts attributable to its service contracts did clearly reflect income under Section 446 of the Code. The court of appeals held "[t]he task of a reviewing court . . . is not to determine whether in its own opinion RCA's method of accounting for prepaid service contract income 'clearly reflect[ed] income', but to determine whether there is an adequate basis in law for the Commissioner's conclusion that it did not" (13a). The appellate court found just such a basis in the "policies" set forth in this Court's trilogy (16a-17a)—even though in RCA's case, the accounting method was found not to suffer from any of the pervasive artificiality of the systems involved in the trilogy (20a).

In holding that a trial court cannot for itself make the threshold determination of whether a method of accounting clearly reflects income—"[t]he issue before the district court was not whether RCA's accounting method adequately reflected income" (20a)—the court of appeals placed itself squarely in conflict with a number of appellate decisions. These decisions recognize not only that a court must determine whether a method of accounting clearly reflects income in order to ascertain whether the Commissioner abused his discretion, but also that the Commissioner has no discretion

to compel a taxpayer to adopt a different method of accounting if the method employed by that taxpayer clearly reflects income. Indeed, one line of such cases arises, just as this case does, in the context of accounting for unearned receipts.

An example of this line is *Artnell Co.* v. *Commissioner*, 400 F.2d 981 (7th Cir. 1968). In *Artnell*, the court recognized the broad discretion possessed by the Commissioner, yet found that discretion abused by the rejection of a deferral technique which clearly reflected income. *Id.* at 984-85. The court of appeals considered the trilogy and the "policies" these decisions reflect, but nevertheless reversed a determination by the Tax Court that deferred revenues were income when received regardless of the merits of the accounting method employed. In direct conflict with the standard of review enunciated by the Second Circuit, the Seventh Circuit remanded and expressly ordered the Tax Court to determine whether the "method of accounting did clearly reflect [the taxpayer's] income . . . ." *Id.* at 985. Thus, the court of appeals in *Artnell* required the trial court to make the precise determination that the court below held to be outside the scope of a trial court's authority. A clearer conflict in understanding what the role of a trial court is in this area cannot exist.[5]

Boise Cascade Corp. v. *United States*, 530 F.2d 1367 (Ct. Cl.) *(per curiam)*, *cert. denied*, 429 U.S. 867 (1976),[6] also upheld a taxpayer's deferral of unearned receipts until the

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[5] On remand the Tax Court found that the method of accounting did clearly reflect income and held in favor of the taxpayer. 29 Tax Ct. Mem. (CCH) 403, 406 (1970).

[6] Conflicts between a court of appeals and the Court of Claims are recognized as a basis for granting of a writ of *certiorari*. *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1, 4 (1974); *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 141-42 (1974); *AAA*, 367 U.S. at 689.

period in which they were earned after having given full consideration to the "policies" which the court of appeals in *RCA* found sufficient to bar a trial court's inquiry into whether RCA's method of accounting clearly reflected income. In *Boise Cascade,* the court found it "necessary to conclude" that the taxpayer's "method of accounting under which income is accrued as the related services are performed clearly reflects its income, and, accordingly, the Commissioner is not authorized by § 446(b) to impose another method of accounting." 530 F.2d at 1378. In fact, the Court of Claims recognized that it is the taxpayer's burden to "show that its method clearly reflects income for the purposes of the Internal Revenue Code." *Id.* at 1372. This is precisely what RCA did at trial and Judge Lasker found that RCA met its burden. It is because of this finding that the court of appeals reversed.[7]

Morgan Guaranty Trust Co. v. *United States,* 585 F.2d 988 (Ct.Cl. 1978), also ruled that the Commissioner abused his discretion in rejecting a taxpayer's method of accounting which clearly reflected income:

> "It is clear that the Commissioner has the power to change a taxpayer's method of tax accounting from a method which distorts income to a method that clearly reflects income. . . . However, where there is no distortion of income . . . it is an abuse of the Commis-

[7] The Second Circuit's opinion, compelling RCA to use the IRS's method of accounting notwithstanding the failure of the IRS's method to reflect income clearly is also directly in conflict with other decisions on another, but related, ground. Uncontradicted expert trial testimony established that the method being forced upon RCA by the IRS failed, by any standard, to reflect income clearly. As the Court of Claims held in *Boise Cascade, supra,* and as the Tenth Circuit Court of Appeals ruled in *Beacon Publishing Co.* v. *Commissioner,* 218 F.2d 697 (10th Cir. 1955), the IRS may not compel a taxpayer to adopt a method of accounting that fails clearly to reflect income.

> sioner's discretion to switch a taxpayer's method of tax accounting to a different method." 585 F.2d at 997.[8]

This line of cases arising in the context of deferral accounting reflects the broader principle that it is an abuse of discretion for the IRS to reject a method of accounting which clearly reflects income. In *Glenn* v. *Kentucky Color & Chemical Co.*, 186 F.2d 975, 978 (6th Cir. 1951) *(per curiam)*, for example, the court of appeals upheld the district court's finding that the method of accounting clearly reflected income and concluded:

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[8] Also inconsistent with the decision of the Second Circuit is *Mooney Aircraft, Inc.* v. *United States*, 420 F.2d 400, 410 (5th Cir. 1970), where the Fifth Circuit Court of Appeals examined in detail the taxpayer's method of accounting in order to determine whether such method clearly reflected income under Section 446 of the Code. *But see Hagen Advertising Displays, Inc.* v. *Commissioner*, 407 F.2d 1105 (6th Cir. 1969), where the court relied on the trilogy as authority for rejecting the deferred reporting of income attributable to the receipt of unearned revenues.

Two other decisions further illustrate the appropriateness of a court examining a taxpayer's method of accounting to determine if it clearly reflects income. In *Collegiate Cap and Gown Co.*, 37 Tax Ct. Mem. (CCH) 960, 965 (1978), the Tax Court found that since "the same factors which led us to find the accounting system in *Artnell* clearly reflected income exist herein, we hold . . . [taxpayer's] method of accounting clearly reflected income." A similar decision, reflecting a comparable method of analysis, was reached by the United States District Court for the Northern District of Illinois in *Automated Marketing Systems, Inc.* v. *United States*, 74-2 U.S.T.C. ¶ 9711 (N.D. Ill. 1974), *aff'd in unpublished opinion* (7th Cir. Jan. 5, 1975), where the court held that the taxpayer's "method of accounting for billings applicable to future mailings clearly reflected its income for each of its 1963 through 1966 taxable years." *Id.* at 85,307.

In addition, since none of the cases in the trilogy overrules the earlier appellate court decisions in *Schuessler* v. *Commissioner*, 230 F.2d 722 (5th Cir. 1956) and *Beacon Publishing Co., supra*, both of which upheld the deferral of unearned revenues until the period in which earned and the authority of a court to find that such a method clearly reflects income, these cases are also in conflict with the decision of the court of appeals below.

> "The Commissioner is not authorized to enact legislation infringing upon the free choice of an accounting system which is given the taxpayer . . . nor to arbitrarily change the accounting system used by the taxpayer where it does clearly reflect its income."

Accord Thompson-King-Tate, Inc. v. *United States,* 296 F.2d 290, 294-95 (6th Cir. 1961); *Heaven Hill Distilleries, Inc.* v. *United States,* 476 F.2d 1327, 1337 (Ct.Cl. 1973) *(per curiam)*. This principle was reaffirmed as recently as last week by the United States Tax Court in *Public Service Co.,* 78 T.C. No. 31, slip op. at 16, 22 (March 22, 1982) where the IRS conceded that it did not have the authority to change a taxpayer's accounting method when it clearly reflected income and the court "conclude[d] that, in the posture of this case, petitioner's method of accounting does clearly reflect income, and therefore we hold that respondent has abused his authority . . . ."

The trilogy provides no support for the court of appeals' ruling that a trial court may not consider whether a taxpayer's method of accounting clearly reflects income in determining whether the Commissioner abused his discretion. In *Michigan,* this Court upheld the Commissioner's exercise of discretion upon finding that the taxpayer's accounting method was "purely artificial and [bore] no relation to the services which petitioner [might] in fact be called upon to render for the member." 353 U.S. at 189 (footnote omitted). The trial court had expressly found that "the petitioner's method of accounting did not clearly reflect its income." *Automobile Club of Michigan,* 20 T.C. 1033, 1047 (1953). *AAA* also found the taxpayer's method of accounting purely artificial and upheld a trial court which found that "[t]he issue to be decided by this court is whether the Commissioner of Internal Revenue correctly

determined that plaintiff's method of accounting . . . does not clearly reflect plaintiff's income. . . ." *American Automobile Ass'n* v. *United States*, 181 F.Supp. 255, 257 (Ct. Cl. 1960). Finally in *Schlude*, this Court upheld a court of appeals determination that the taxpayers' method "does not, for income tax purposes, clearly reflect income." *Schlude* v. *Commissioner*, 296 F.2d 721, 722 (8th Cir. 1961) *(per curiam)*. This Court itself considered the method employed and found it did "not clearly reflect income," 372 U.S. at 136. Thus, in each case in the trilogy, this Court approved the consideration by a trial court of whether a method of accounting clearly reflected income—a question that was faithfully considered by the district court below and which the court of appeals, in reversing the district court, now contends was beyond the power of the district court to answer.

This Court's decision in *Thor*, upon which the court below relied for its absolutist holding on the appropriate standard of review, neither supports that standard nor undermines the validity of the authorities in conflict with the court below. *Thor* recognized that the IRS is vested with wide discretion to determine whether a particular method of accounting clearly reflects income. 439 U.S. at 532. *Thor* also recognized, however, that "the Commissioner's discretion is not unbridled and may not be arbitrary . . . ." *Id.* at 533.[9] The issue, then, is whether the rejection by the IRS

[9] *Thor* does not forbid a court from considering whether a method of accounting clearly reflects income. In *Thor* this Court found that the Commissioner did not abuse his discretion expressly because the method of accounting being challenged "was plainly inconsistent with the governing [Treasury] Regulations which the taxpayer, on its part, has not challenged." *Id.* at 533 (footnote omitted). The standard announced by the decision below may well be suitable to a situation where the method of accounting is forbidden by a Treasury regulation, because, in that instance, the question of whether an accounting method clearly reflects income is completely irrelevant. Here, however, no regulation or ruling

of a method of accounting found to be clearly reflective of income is arbitrary.

As the authorities cited above establish, when a method of accounting clearly reflects income, the Commissioner abuses his discretion by requiring the taxpayer to change it. It is thus the responsibility of the trial court to make the threshold determination of whether a taxpayer's accounting method clearly reflects income in order to determine whether there has been an abuse of discretion. Once the trial court has determined that a method of accounting clearly reflects income, the Commissioner's failure to accept such determination must be rejected as an abuse of discretion, even under *Thor*. Yet, the court of appeals held that the trial court cannot consider this question, and in this regard, it stands in conflict with other appellate courts that have addressed the issue.

The question whether a trial court can independently determine whether any basis existed for the IRS's exercise of discretion under Section 446(b) is of critical importance because if it cannot, "policies" such as the "expeditious collection of tax revenues" (16a-17a) can always be invoked to uphold the IRS's exercise of discretion in increasing a taxpayer's tax burden. The courts would be abdicating their responsibility in connection with the enforcement of the Internal Revenue Code if they were to defer—as the court of appeals did below—to arbitrary IRS action on the basis of such amorphous policies.

Beyond the issue of the proper role of the courts in reviewing IRS action, the decision below has far-reaching

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forbids use of RCA's method of accounting. To the contrary, the IRS has adopted a revenue procedure and revenue ruling which expressly authorize the deferral by taxpayers of income from unearned receipts until the period in which the income was earned. Rev.Proc. 71-21, *supra;* Rev.Rul. 71-299, *supra.*

implications because of the alleged "policies" invoked by the court. To the extent that its ruling was premised on its perception of this Court's hostility to statistical methods the court of appeals apparently was under the mistaken impression that statistical analysis has no role in determining taxable income. Nothing could be further from the truth.[10] The court of appeals' decision poses particularly grave consequences for the many taxpayers throughout this country who use statistical methods in reporting income on the accrual method of accounting.[11] The decision below rec-

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[10] This perception seems to have been derived from the court's reading of *Thor*. *Thor* did not, however, forbid, because of "uncertainty", the use of statistical methods in determining taxable income. To the contrary, *Thor* acknowledged the propriety of using statistical methods in both areas before it. The Court upheld the use of a statistical method based on prior experience (such as RCA's) in the calculation of bad debt deductions. 439 U.S. at 546-50. On the inventory issue, the taxpayer in *Thor* was faulted because it merely "guess[ed]" inventory values (*id.* at 536) and failed to obtain such evidence of fair market price at dates nearest the inventory as might have been available. *Id.* at 534. The latter is a statistical method designed to project, based on past experience, what the present value of an inventory item would be. This statistical method is, of course, far more likely to lead to "uncertainty" than the method used by RCA, yet it is acceptable. Unlike *Thor*, which involved the taxpayer's "subjective estimates" of inventory value rather than projections based on past experience, and thus enabled the "taxpayer . . . 'to determine how much tax it wanted to pay for a given year' ", *id.* at 536, RCA's system was based entirely on objective criteria. It had, in the words of this Court in *AAA*, "performance justification". 367 U.S. at 692.

[11] Courts have repeatedly recognized that taxpayers may use appropriate statistical methods in determining income and deductions. *See, e.g. Pennsylvania Power & Light Co.* v. *United States*, 411 F.2d 1300 (Ct. Cl. 1969) (*per curiam*) (useful life); *Norman R. Davies*, 42 Tax Ct. Mem. (CCH) 768 (1981) (wagering income); *Southern Pacific Transportation Co.*, 75 T.C. 497 (1980) (useful life); *Earl Hightower*, 31 Tax Ct. Mem. (CCH) 1250 (1972) (working interest in oil and gas leases); *Black Motor Co.*, 41 B.T.A. 300 (1940), *aff'd on other grounds*, 125 F.2d 977 (6th Cir. 1942) (bad debts). In *Southern Pacific*, the Tax Court relied on the district court's decision below for the proposition that an "accrual basis taxpayer could use 'adequately supported statis-

ognized that RCA's statistical method of matching revenues with expenses did not suffer from the artificiality of the method used by the taxpayers in the trilogy (20a).[12] Thus, in rejecting RCA's method, the court of appeals raised the broader question as to the validity in general of using scientifically based statistical methods in the computation of taxable income under the accrual method of accounting. The court of appeals' decision ignores the widely-established use of such statistical methods in determining the accurate matching of revenues with expenditures, and accords to the IRS—in the name of "policy"—absolute discretion to reject such methods of accounting no matter how precisely or how clearly they reflect income.

Finally, the very opinions of the lower courts that have addressed the propriety of deferral accounting in the almost two decades since this Court last considered the issue provide a compelling argument for the granting of the writ

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tical projections' to defer a portion of prepaid income." 75 T.C. at 792 & n.349. Indeed, in addition to Rev. Proc. 71-21, the IRS itself has repeatedly endorsed the use of statistics. *See, e.g.*, Treas. Reg. § 1.47-1(e)(2)(i) (investment credit); Treas.Reg. § 1.167(a)-11(d)(3)(v)(d)(1) (depreciation); Treas.Reg. § 1.451-4(c)(6) (accounting for redemption of trading stamps); Treas.Reg. § 1.453-2(d) (installment sales treatment for revolving credit plans); Treas.Reg. § 1.471-11(d)(2)(ii)(b) (inventories); Treas. Reg. § 1.482-2(e)(1)(iv) (allocation of income between related taxpayers); Rev.Proc. 81-70, 1981-52 I.R.B. 29 (computation of basis of stock acquired in a reorganization); Rev.Proc. 64-4, 1964-1 C.B. (Part I) 644 (charges under a revolving credit plan which may be treated as sales on the installment plan).

[12] None of the methods of accounting rejected in the trilogy as not clearly reflecting income involved the use of statistical projections in the matching of revenues with expenses, but instead arbitrarily spread income over the contractual periods. Indeed, in *Schlude*, the last case in the trilogy, this Court found that the principal flaw in the taxpayer's accounting method was its failure to utilize a statistical method to project the extent of the services and related expenditures to be rendered by the taxpayers in future years. 372 U.S. at 136 & n.9.

of *certiorari* in this case. For instance, describing this area of law as a "melange" of conflicting authority, the Court of Claims in *Boise Cascade* recognized that "one can hardly speak with complete confidence in this troublesome and confusing area of tax law . . . ." 530 F.2d at 1374, 1377. The Court of Appeals for the Fifth Circuit in *Mooney Aircraft* found "this [an] extremely confused area of law." 420 F.2d at 409. Judge Lasker himself found the precedent upon which he had to base his decision as "cryptic" and characterized by "opacity" (41a).

We submit that in view of the clear conflict between the decision below and other decisions, in view of the significance of the issues involved and in view of the unquestionable and judicially recognized need for clarification in this area of law, the writ of *certiorari* should be granted.

2. The Court of Appeals' Ruling on the Regulations under Section 381(c)(4) of the Code Creates a Conflict between Appellate Courts and Raises Significant and Recurring Problems as to the Applicability of these Regulations.

The district court held that RCA was entitled to adopt the accrual method of accounting under "the only plausible reading" of the "special rules" in the regulations under Section 381(c)(4). The district court relied on both the explicit and unambiguous language of Treas.Reg. § 1.381 (c)(4)-1(e)(1) (99a-100a) and the evident remedial purpose of the regulation's special rules. Insofar as pertinent, the special rules allowed RCA to adopt the method of accounting it did adopt for the business acquired in the liquidation of RCAS if two—and only two—conditions were satisfied: (1) the liquidation occurred before the regulations were promulgated on August 5, 1964 and (2) the liquidation

occurred in a year that is barred by the statute of limitations. There is no dispute that these two conditions were satisfied. The sound good sense of the special rules—which proscribe retroactive application of the subsequently adopted regulations where relevant taxable years are closed by the statute of limitations—is equally clear.

In reversing the district court, the Second Circuit held that *none* of the regulations applies to a merger or liquidation unless the parties used different methods of accounting. Because *none* of the regulations applies, so the argument goes, the special rules in particular cannot apply. The court's assertion that none of the Section 381(c)(4) regulations applies when the two parties to the transaction use the same method of accounting is, however, patently incorrect. It is irreconcilable with the regulations themselves, as well as with consistent IRS interpretations of those regulations, and directly contrary to a case decided by the United States Court of Claims, *VCA Corp.* v. *United States*, 1977-2 U.S.T.C. ¶ 9554 (Ct.Cl. Tr. Div.), *aff'd per curiam*, 1977-2 U.S.T.C. ¶ 9736 (Ct.Cl. 1977).

VCA held that the Section 381(c)(4) regulations *do* apply to a merger in which both parties used the same accrual method of accounting. Although the special rules under Section 381(c)(4) were not in issue in that case, the square holding of the Court of Claims that other provisions of the regulations do apply even where the two parties to the transaction used the same method of accounting is in conflict with the Second Circuit's conclusion in the instant litigation that "[t]he regulations under § 381(c)(4) . . . by their terms do not purport to apply to taxpayers who have acquired companies not using a different method of accounting" (23a). If the Court of Claims is correct—and it is—the rationale for the Second Circuit's decision is completely undermined.

The Second Circuit's holding also conflicts with two published IRS revenue rulings and five extended passages in the Section 381(c)(4) regulations themselves. Both Revenue Ruling 70-83, 1970-1 C.B. 85, and Revenue Ruling 70-241, 1970-1 C.B. 84, apply in cases in which the companies in question used the same methods of accounting. Two passages in the regulations under Section 381(c)(4) (Treas. Reg. §§ 1.381(c)(4)-1(b)(1) and 1.381(c)(4)-1(b)(3)(i)) (82a-86a) *explicitly* apply where both parties used the same method of accounting. Three other passages in the regulations (Treas.Reg. §§ 1.381(c)(4)-1(a)(1)(ii), 1.381(c)(4)-1(a)(2) and 1.381(c)(4)-1(b)(4)) must be read to apply to transactions involving companies using the same methods of accounting (80a-89a).

The district court's decision, which recognized the literal applicability of the special rules in the regulations under Section 381(c)(4) to the instant case and which found that a solid policy basis existed for those rules being written as they were (62a-63a), should have been affirmed by the court of appeals. Instead, the court of appeals' unfounded reversal of the district court on this point has potential repercussions far beyond this case.

Unless this decision is corrected by this Court, the most commonplace mergers and liquidations, involving corporations using the same methods of accounting, will suddenly have to proceed outside the coverage of any regulations under Section 381(c)(4). By virtue of the court of appeals' ruling in this case, neither the IRS nor corporate tax planners may rely any longer on the guidelines set forth in the Section 381(c)(4) regulations where the companies in a transaction use the same method of accounting.[13]

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[13] Indeed, if the court of appeals is correct, the IRS was mistaken in the following private letter rulings issued after the

The question here is simply whether the court of appeals erred in holding that the Treasury regulations governing accounting for mergers and liquidations have no applicability to the most common mergers and liquidations. The ramifications of this holding extend well beyond the court's clearly erroneous decision in this case. Review by the Supreme Court is the sole remedy available to correct this unfortunate and unnecessary development in the federal tax law.[14]

Second Circuit's decision: Private Rulings 8211070 (Dec. 17, 1981), 8211068 (Dec. 17, 1981), 8210103 (Dec. 14, 1981), 8208197 (Nov. 30, 1981), 8208165 (Nov. 30, 1981), 8208141 (Nov. 30, 1981), 8208116 (Nov. 27, 1981), and 8208115 (Nov. 27, 1981).

[14] The correctness of the court of appeals' decision below, even assuming, *arguendo*, the propriety of the statutory tests and standards of review involved, is open to additional serious question. Throughout this litigation, RCA has contended that even if it were found not to be entitled to a refund for the entire amount of its tax on income deferred during 1958 and 1959, it is at least entitled to a refund representing the tax paid on the amount which Revenue Procedure 71-21 and Revenue Ruling 71-299 recognize as having been correctly deferred in its return (as set forth in the stipulation of the parties, 75% of the total claim). The court of appeals concluded "we need not decide whether Rev. Proc. 71-21 and Rev. Rul. 71-299 are retroactive. Both require the taxpayer to obtain the Commissioner's consent before employing the accounting procedures permissible under them. Rev. Proc. 71-21 at 5.01. RCA has neither sought nor obtained the Commissioner's consent to adopt these procedures. Accordingly, it may not use them even if the Procedure and Ruling are retroactive" (23a). In the first place, Revenue Ruling 71-299 does not incorporate the consent provisions of Section 5 of Revenue Procedure 71-21, but only the substantive provisions, and, therefore, Revenue Ruling 71-299 is retroactive pursuant to Code § 7805(b) and Treas.Reg. § 601.601(d)(2)(v)(e) without regard to the procedural consent provisions of Section 5. Second, the broad assertion by the Second Circuit disregards the parties' stipulation of facts, consistent with the relevant documentary evidence, which expressly confirms that RCA *did* request the consent of the IRS to adopt the method of accounting permitted by Revenue Procedure 71-21.

CONCLUSION

For these reasons, a writ of *certiorari* should issue to review the opinion and judgment of the Second Circuit Court of Appeals entered on November 13, 1981 and its order of December 30, 1981.

Respectfully submitted,

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March 30, 1982

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Order of the United States Court of Appeals, entered on December 30, 1981

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse, in the City of New York, on the 30th day of December, one thousand nine hundred and eighty-one.

No. 80-6240

RCA CORPORATION,

Plaintiff-Appellee,

v.

UNITED STATES OF AMERICA,

Defendant-Appellant.

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the plaintiff-appellee, RCA Corporation,

Upon consideration by the panel that heard the appeal, it is

ORDERED that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges of the court in

Order of the United States Court of Appeals, entered on December 30, 1981

regular active service and to any other judge on the panel that heard the appeal and that no such judge has requested that a vote be taken thereon.

/s/ A. Daniel Fusaro
A. Daniel Fusaro
Clerk

By Francis X. Gindhart
Chief Deputy Clerk

Opinion of the United States Court of Appeals, entered on November 13, 1981

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

No. 1273, Docket 80-6240

RCA CORPORATION,

Plaintiff-Appellee,

v.

UNITED STATES OF AMERICA,

Defendant-Appellant.

Argued May 29, 1981—Decided November 13, 1981

Leslie R. Bennett, Asst. U. S. Atty., New York City (John S. Martin, Jr., U. S. Atty. S. D. N. Y., Michael H. Dolinger, David M. Jones, Asst. U. S. Attys., New York City, on the brief), *for defendant-appellant.*

Walter C. Cliff, New York City (George Wailand, Benjamin J. Cohen, Richard Coll, Cahill Gordon & Reindel, New York City, on the brief), *for plaintiff-appellee.*

Before FEINBERG, *Chief Judge,* and MANSFIELD and KEARSE, *Circuit Judges.*

KEARSE, *Circuit Judge:*

This appeal requires us to determine whether the Commissioner of Internal Revenue ("Commissioner") properly exercised his discretion when he rejected as "not clearly reflect[ing] income" within the meaning of § 446(b) of the Internal Revenue Code of 1954 ("I.R.C."), 26 U.S.C.

§ 446(b) (1976), the accrual method of accounting used in 1958 and 1959 by plaintiff RCA Corporation ("RCA") to account for revenues received from the prepayment of fees associated with certain service contracts entered into with purchasers of its products. The United States District Court for the Southern District of New York, 499 F. Supp. 507, Morris E. Lasker, *Judge*, held, after a bench trial, that the Commissioner had abused his discretion in rejecting RCA's accrual method of accounting, and awarded judgment to RCA in the amount of $5,956,039.25, plus assessed deficiency interest and statutory interest, on its claim for a refund of corporate income taxes for the years 1958 and 1959. Believing that the Commissioner properly exercised his discretion, we reverse.

I

The case was tried largely on a stipulated record and the facts are substantially undisputed. Since 1946 RCA has carried on a business, either directly or through its wholly-owned subsidiary RCA Service Company ("RCAS"), of servicing television sets and other consumer products it sold. In the typical service arrangement, the purchaser of an RCA product would contract, at the time of purchase, to receive service and repair of the product for a stated period in exchange for prepayment of a single lump sum.[1]

[1] In a certain proportion of the service contracts, the customer paid only a portion of the contract price at the beginning of the contract term, and paid the balance in installments at stated intervals during the contract term. Prepayments received under such contracts were treated in substantially the same manner as those received under contracts requiring prepayment in full. Figures stating income from service contract prepayments excluded the installment payments RCA expected to receive in the future.

Under these agreements, service was available to the purchaser on demand at any time during the contract term, which might range from three to twenty-four months. Until 1958, this service business was conducted by RCAS. On December 31, 1957, however, RCAS was liquidated by means of its merger into RCA; thereafter RCA continued the business of RCAS through RCA's Service Company division.

RCAS, and later RCA, employed an accrual method of accounting for service contract revenues on their books. For each group of service contracts of a given duration entered into a given month, the seller credited to current income a sum that represented the actual cost of selling and processing the contracts, plus a profit. The balance of the revenues derived from each group of contracts, # i. e.,* the portion to be earned through future performance under them, was credited to a deferred income account. Each month thereafter, the seller journaled from the deferred income account to current income that proportion of the revenues from each group of contracts that the seller estimated had been earned in the month through actual performance. For the most part, the seller's estimates of its rate of performance for a particular class of contracts were based on its past experience in the business, and took into account such factors as seasonal repair patterns, variations in average daily workloads, and the number of working days in each month.[2] Although these forecasts were not

[2] The companies had learned from experience that customers were more likely to seek service during certain seasons and on certain days of the week than they were at other times. RCA's statistics projected future demand on the basis of observed variations in past demand.

perfect and may have rested to some extent on untested assumptions, they matched service contract revenues and related expenses with reasonable accuracy.

Although RCAS accounted for service contract revenues on an accrual basis in keeping its own books, it employed a cash method of accounting for service contract income on its tax returns.[3] For tax purposes, RCAS added to its gross taxable income for each year the amount by which the aggregate year-end balance in its deferred service contract income accounts exceeded the previous year's closing balance; if the accounts had decreased, RCAS subtracted the amount of the decrease from its gross taxable income.

After the liquidation of RCAS, RCA continued to employ RCAS's accrual method, based on reasonably accurate forecasts of monthly variations in the demand for service, in its book accounting for the prepaid service contract income of its Service Company division. For tax purposes, however, RCA discontinued RCAS's former practice of adjusting taxable income by the amount of the annual change in the deferred service contract income accounts. Instead, RCA reported the service contract income of the Service Company division on the same accrual basis used in its books, including in taxable gross income only those service contract revenues that it estimated it had earned during the taxable year by actual performance. Thus, although the aggregate balance of the deferred income accounts increased from $8,223,755.27 to $9,497,896.51 between December 31, 1957 and December 31, 1958, RCA did not add to its gross taxable income for 1958 the $1,274,141.24

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[3] Although RCAS had employed an accrual method of tax accounting for this income in 1946 and 1947, it adopted the cash method in 1948, after the Commissioner rejected its accrual method as not clearly reflecting income.

increase. Similarly, RCA did not include in its gross income for 1959 the $1,956,024.68 increase, to $11,453,921.19, that occurred in that year. In addition, in an adjustment designed to reconcile differences in book and taxable income, RCA reduced its 1958 taxable income by $7,624,775.27, thus eliminating from taxable income most of the $8,223,755.27 balance in the RCAS deferred income accounts (on which RCAS had already paid taxes) that had been credited to RCA's book income accounts after the merger. RCA reduced its taxable income for 1959 by $598,980 through a similar adjustment. These accounting changes and adjustments had the effect of reducing RCA's 1958 income taxes by $4,627,436.59 and its 1959 income taxes by $1,328,602.66. In neither 1958 nor 1959 did RCA seek the Commissioner's permission, pursuant to I.R.C. § 446(e), to adopt its accrual method of tax accounting for service contract income.[4]

After an audit of RCA's tax returns for 1958 and 1959, the Internal Revenue Service ("IRS") required RCA to report its service contract revenues upon receipt, rather than deferring recognition of any portion of them. For 1958, this change from accrual to cash accounting increased RCA's taxable income by $8,898,916.51 and increased its tax liability by $4,627,436.59. For 1959, the adjustment increased taxable income by $2,555,004.68 and tax liability by $1,328,602.66. RCA paid these increased income taxes

[4] Section 446(e) provides as follows:

> (e) Requirement respecting change of accounting method.—Except as otherwise expressly provided in this chapter, a taxpayer who change the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary.

and filed timely administrative claims for refund of the disputed sums. RCA commenced this litigation on June 18, 1969, and, after what seems to have been a lengthy interregnum of fruitless settlement talks, the case was tried in 1979.

At trial, RCA contended, first, that its accrual method of tax accounting for perpaid service contract revenues "clearly reflect[ed] income" within the meaning of I.R.C. § 446(b), and that the Commissioner had therefore abused his discretion in rejecting that method.[5] Alternatively, RCA argued that its adoption of the accrual method after its merger with RCAS was permissible under regulations promulgated pursuant to I.R.C. § 381(c)(4), concerning an acquiring corporation's assumption of an acquired corporation's accounting practices.[6] Finally, RCA asserted that its accrual method was acceptable because certain revenue rulings, Rev.Proc. 71-21, 1971-2 C.B. 549, and Rev.Rul.

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[5] Sections 446(a) and (b) provide as follows:

(a) General rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) Exceptions.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

[6] Section 381(c)(4) provides as follows:

(4) Method of accounting.—The acquiring corporation shall use the method of accounting used by the distributor or transferor corporation on the date of distribution or transfer unless different methods were used by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of computing taxable income adopted pursuant to regulations prescribed by the Secretary.

71-299, 1971-2 C.B. 218, promulgated by the Commissioner in 1971 and permitting limited use of accounting procedures such as RCA's, are retroactive in effect.[7]

For its part, the government argued that under a trio of Supreme Court Cases, *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180, 77 S.Ct. 707, 1 L.Ed.2d 746 (1957), ("*Michigan*"); *American Automobile Association* v. *United States,* 367 U.S. 687, 81 S.Ct. 1727, 6 L.Ed.2d 1109 (1961) ("*AAA*"), and *Schlude* v. *Commissioner,* 372 U.S. 128, 83 S.Ct. 601, 9 L.Ed.2d 633 (1963) ("*Schlude*"), methods of accrual accounting based on projections of customers' demands for services do not "clearly reflect income," and that in view of these decisions the Commissioner did not abuse his discretion in rejecting RCA's method. The government also pressed a broader argument that accrual accounting is *never* permissible without express legislative authorization and the Commissioner's consent. In addition, the government contended that RCA was not entitled to a refund because its adoption of the accrual method was a change of accounting methods for which it was required to, but did not, obtain the Commissioner's consent under I.R.C. § 446(e). Finally, the government argued that

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[7] Section 3.02 of Revenue Procedure 71-21, on which RCA relies, provides, in relevant part:

> An accrual method taxpayer who, pursuant to an agreement (written or otherwise), receives a payment in one taxable year for services, where all of the services under such agreement are required by the agreement as it exists at the end of the taxable year of receipt to be performed by him before the end of the next succeeding taxable year, may include such payment in gross income as earned through the performance of the services, ...

Revenue Ruling 71-299 simply states that Revenue Procedure 71-21 supercedes several earlier revenue rulings to the extent that they are inconsistent with the new Revenue Procedure.

the regulations promulgated under I.R.C. § 381(c)(4)[8] were inapplicable to the RCA-RCAS merger, and that Rev.Proc. 71-21 and Rev.Rul. 71-299 are not retroactive.

After reviewing the stipulated facts and hearing the testimony of the one live witness, an accounting expert, the district court ruled for RCA. The court read *Michigan*, *AAA*, and *Schlude*, *supra*, to proscribe, as "not clearly reflect[ing] income," only those methods of deferring recognition of income that are not based on demonstrably accurate projections of future expenses required to earn the income. In addition, the court expressed its belief in the continued vitality of our decision in *Bressner Radio, Inc.* v. *Commissioner*, 267 F.2d 520 (2d Cir. 1959), *nonacq.*, Rev.Rul. 60-85, 1960-1 C.B. 181 (1960), decided after *Michigan* but before *AAA* and *Schlude*, in which we held that deferral methods of accounting based upon reasonably accurate estimates of future costs were permissible under I.R.C. § 446. Finding that RCA's accrual method matched service contract revenues and related expenses "with reasonable precision" and therefore "clearly reflect[ed] income," the court held that the Commissioner had abused his discretion under I.R.C. § 446(b) in rejecting RCA's method and imposing on RCA a cash method of accounting.

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[8] Treasury Regulation § 1-381(c)(4)-1(e) provides, in relevant part:

> If the date of distribution or transfer was before August 5, 1964, and if the assessment of any deficiency or the refund or credit of any overpayment for the taxable year of the acquiring corporation which includes the date of distribution or transfer or any subsequent taxable year is prevented by the operation of [the statute of limitations], then this section does not authorize the Commissioner or the acquiring corporation to change any method or methods of accounting in any taxable year of the acquiring corporation.

Alternatively, the district court held that RCA's adoption of its accrual method of accounting was insulated from challenge by Treas.Reg. § 1-381(c)(4)-1(e) (1964), promulgated pursuant to I.R.C. § 381(c)(4). In addition, the court rejected the government's argument that the Commissioner may disallow any deferred-income method of accounting that is not specifically authorized by statute, and it held that RCA was not barred from seeking a refund by its failure to secure the Commissioner's consent for its adoption of its accrual method. The court found is unnecessary, in view of its disposition of the other issues, to discuss the parties' contentions concerning the retroactivity of Rev.Proc. 71-21 and Rev.Rul. 71-299.

Accordingly, the district court entered judgment for RCA in the amount of $4,627,436.59 for 1958 and $1,328,602.66 for 1959, plus deficiency interest previously assessed against and paid by RCA on those sums, plus statutory interest. This appeal followed.

On appeal, the Commissioner renews the various contentions he pressed at trial, two of which have merit. We conclude that the district court erred in holding, first, that the Commissioner abused his discretion in rejecting RCA's accrual method of accounting for prepaid service contract revenues, and, second, that Treas.Reg. § 1-381(c)(4)-1(e) precluded the Commissioner from challenging RCA's adoption of that method.

II

This case well illustrates the fundamental tension between the purposes of financial accounting and those of tax accounting. As the Supreme Court has recognized, these two systems of accounting have "vastly different objectives":

> The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets." In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light.

Thor Power Tool Co. v. *Commissioner*, 439 U.S. 522, 542, 99 S.Ct. 773, 786, 58 L.Ed.2d 785 (1979) (footnote omitted; brackets in original). The case also highlights the fundamentally different perspective that courts must adopt when reviewing the propriety of an exercise of administrative discretion rather than deciding a naked question of substantive law. We conclude that the district court gave too little weight to the objectives of tax accounting and to the Commissioner's wide discretion in implementing those objectives.

Section 446 of the Internal Revenue Code of 1954 provides that "[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books," unless "the method used does not clearly reflect income" ; in the

latter event "the computation of taxable income shall be made under such method as, in the opinion of the Secretary [of the Treasury], does clearly reflect income." I.R.C. § 446(a),(b). It is well established that the Commissioner enjoys "broad discretion" to determine whether, " 'in [his] opinion,' " a taxpayer's accounting methods clearly reflect income, *Thor Power Tool, supra,* 439 U.S. at 540, 99 S.Ct. at 785 (quoting 26 C.F.R. § 1.446-1(a)(2)), and the Commissioner's exercise of his discretion must be upheld unless it is clearly unlawful:

> In construing § 446 and its predecessors, the Court has held that "[t]he Commissioner had broad powers in determining whether accounting methods used by a taxpayer clearly reflect income." *Commissioner* v. *Hansen,* 360 U.S. 446, 467, 79 S.Ct. 1270, 1281, 3 L.Ed. 2d 1360 (1959). Since the Commissioner has "[m]uch latitude for discretion," his interpretation of the statute's clear-reflection standard "should not be interfered with unless clearly unlawful." *Lucas* v. *American Code Co.,* 280 U.S. 445, 449, 50 S.Ct. 202, 203, 74 L.Ed. 538 (1930).

Thor Power Tool, supra, 439 U.S. at 532, 99 S.Ct. at 780; *Lucas* v. *Kansas City Structural Steel Co.,* 281 U.S. 264, 271, 50 S.Ct. 263, 265, 74 L.Ed. 848 (1930); *Burck* v. *Commissioner,* 533 F.2d 768, 772-73 (2d Cir. 1976). The task of a reviewing court, therefore, is not to determine whether in its own opinion RCA's method of accounting for prepaid service contract income "clearly reflect[ed] income," but to determine whether there is an adequate basis in law for the Commissioner's conclusion that it did not. Our review of the relevant decisions persuades us that the law adequately supports the Commissioner's action.

In *Michigan, supra,* the first Supreme Court ruling on tax accounting for income received in respect of services to be performed in the future upon demand, the taxpayer received income in the form of prepaid membership dues and promised, in exchange, to perform various services for its members upon demand at any time during the twelve-month term of the membership agreement. In order to match prepaid dues revenues with related expenses, the taxpayer assumed that members would demand services at a constant rate during the contract term and credited prepaid membership dues to current income on a monthly pro rata basis to match the hypothetical rate of demand for services. The Supreme Court upheld the Commissioner's rejection of this method, reasoning that it was "purely artificial and [bore] no relation to the services which [the taxpayer] may in fact be called upon to render." 353 U.S. at 189, 77 S.Ct. at 712.

Not long after *Michigan* was decided, however, this Court, in *Bressner Radio, Inc.* v. *Commissioner, supra,* upheld a method of deferral accounting for prepaid service contract income that resembled the method rejected in *Michigan.* The taxpayer in *Bressner Radio* contracted to service television sets on demand for a period of one year in exchange for prepayment of a stated fee; the taxpayer recognized 25% of the prepayment as income upon receipt and the remainder over the twelve-month contract term. Although the *Bressner* taxpayer's method of accounting for service contract income was thus nearly identical to that employed by the taxpayer in *Michigan,* this Court distinguished *Michigan,* and ruled for the taxpayer, on the ground that the taxpayer had shown that it experienced "a reasonably uniform demand for services," so that its

recognition of income on a pro rata basis predicted its costs of performance with reasonable accuracy and was not "purely artificial" within the meaning of *Michigan*. 267 F.2d at 528-29.

Subsequently, in *AAA*, *supra*, a Supreme Court case that involved a method of deferring recognition of prepaid membership dues income "substantially identical," 367 U.S. at 691, 81 S.Ct. at 1729, to that employed by the taxpayer in *Michigan*, the taxpayer argued that the Commissioner had abused his discretion in rejecting its deferral method of accounting because it had shown at trial that its method accorded with generally accepted accounting principles and was justified by its past experience in providing services. Despite this showing, the Court upheld the Commissioner's rejection of the method. The Court stated as follows:

> When [the] receipt [of prepaid dues] as earned income is recognized ratably over two calendar years, without regard to correspondingly fixed individual expense or performance justification, but consistently with overall experience, their accounting doubtless presents a rather accurate image of the total financial structure, but fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner.
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> • • •
>
> [F]indings merely reflecting statistical computations of average monthly cost per member on a group or pool basis are without determinate significance to our decision that the federal revenue cannot, without legislative consent and over objection of the Commissioner, be made to depend upon average experience in rendering performance and turning a profit.

Id. 367 U.S. at 692-93, 81 S.Ct. at 1729-30.

Finally, in *Schlude, supra,* the third Supreme Court case on the subject, the taxpayers, operators of a dance studio, contracted with some of their students to provide a specified number of dancing lessons in exchange for a prepaid fee; the lessons were to be given from time to time, as the student specified, during the contract term. For both tax and book accounting purposes, the taxpayers credited contract prepayments to a deferred income account, and then at the end of each fiscal period credited to current income for that period the fraction of the contract price that represented the fraction of the total number of hours of instruction available under the contract that the student had actually used during the period. In addition, if for more than a year a student failed to request any lessons, the taxpayer treated the contract as cancelled and recognized gain to the extent of the amount of the student's prepayment. Despite the fact that the taxpayer's method of accounting was based largely on its actual performance of services during the taxable year, the court upheld the Commissioner's rejection of the method, viewing the case as "squarely controlled" by *AAA*, 372 U.S. at 134, 83 S.Ct. at 604, because the taxpayer was required to perform services under its contracts only at the student's demand, *id.* at 135, 83 S.Ct. at 605.

The policy considerations that underlie *Michigan, AAA,* and *Schlude* are quite clear. When a taxpayer receives income in the form of prepayments in respect of services to be performed in the future upon demand, it is impossible for the taxpayer to know, at the outset of the contract term, the amount of service that his customer will ultimately require, and, consequently, it is impossible for the taxpayer to predict *with certainty* the amount of net income, *i. e.,*

the amount of the excess of revenues over expenses of performance, that he will ultimately earn from the contract. For purposes of financial accounting, this uncertainty is tolerable; the financial accountant merely estimates future demands for performance and defers recognition of income accordingly. Tax accounting, however, "can give no quarter to uncertainty." *Thor Power Tool, supra,* 439 U.S. at 543, 99 S.Ct. at 786. The entire process of government depends on the expeditious collection of tax revenues. Tax accounting therefore tends to compute taxable income on the basis of the taxpayer's present ability to pay the tax, as manifested by his current cash flow, without regard to deductions that may later accrue. *See* Silk, *Advance Payments-Prepaid Income: Recent Developments; An Old Problem Put to Rest,* 30 N.Y.U.Inst.Fed.Tax, 1651, 1653-54 (1972). By the same token, tax accounting is necessarily hostile to accounting practices that defer recognition of income, and thus payment of the tax on it, on the basis of estimates and projections that may ultimately prove unsound.

In view of the relevant Supreme Court decisions and the policies they reflect, we cannot say that the Commissioner abused his discretion in rejecting RCA's method of accounting for service contract income. Like the service agreements at issue in *Michigan, AAA,* and *Schlude,* RCA's service contracts obligated it to perform services only upon the customer's demand. Thus, at the beginning of the contract term, RCA could not know the extent of the performance that the customer might ultimately require, and it could not be certain of the amount of income that it would ultimately earn from the contract. The Commissioner was not required to subject the federal revenues to the vicis-

situdes of RCA customers' future demands for services. Accordingly, he acted within his discretion in requiring RCA to report its prepaid service contract income upon receipt.

RCA's arguments against the Commissioner's exercise of his discretion are unpersuasive. RCA contends principally that its accounting method must be upheld on the basis of our decision in *Bressner Radio, supra,* which as noted above, upheld an accounting system that was based on reasonably accurate predictions of the demand for services. We think, however, that the Supreme Court's post-*Bressner* decisions in *AAA* and *Schlude* have deprived *Bressner* of controlling force. First, the *AAA* Court seems to have believed that it was overruling *Bressner,* for the Court stated that it had granted certiorari to review the lower court's decision in *AAA* because it perceived "a conflict between" that decision, which the Court affirmed, and our contrary ruling in *Bressner. See AAA, supra,* 367 U.S. at 689, 81 S.Ct. at 1728. *See also Automobile Club of New York, Inc.* v. *Commissioner,* 304 F.2d 781, 786 (2d Cir. 1962) (Clark, J., concurring in the result) (*AAA* contains "quite specific rejection" of *Bressner*); *Hagen Advertising Displays, Inc.* v. *Commissioner,* 407 F.2d 1105, 1109 (6th Cir. 1969) (*Bressner* rejected in *AAA*); *Franklin Life Insurance Co.* v. *United States,* 399 F.2d 757, 763 (7th Cir. 1968) (same), *cert. denied,* 393 U.S. 1118, 89 S.Ct. 989, 22 L.Ed.2d 122 (1969). Second, the holdings of *AAA* and *Schlude* are sufficiently contrary to that of *Bressner* that we must regard *Bressner* as invalid even if *AAA* did not expressly overrule it. As *AAA* and *Schlude* make plain, it is not simply the "artificiality" of a taxpayer's method of deferring recognition of income from services perform-

able on demand that offends the clear reflection principle of § 446(b), but rather the uncertainty inherent in any method that relies on prognostications and assumptions about the future demand for services. The method upheld by us in *Bressner* relied on such prognostications as much as did the methods rejected in *AAA* and *Schlude*. Because the latter cases underscore the Commissioner's discretion to disallow accounting methods that subject the federal revenues to such uncertainty, we cannot invoke *Bressner* to invalidate the Commissioner's exercise of his discretion here.[9]

Equally unpersuasive are RCA's efforts to distinguish *AAA* and *Schlude*. RCA contends that the accounting practices at issue in those cases, which were based on the past demand for services, differ significantly from its own, which was based on relatively scientific projections of the future demand for services, and that its accounting method was valid under *AAA* and *Schlude* even if *Bressner* is disregarded. We think, however, that the differences between RCA's method and the others are immaterial in the present context. As noted above, the vice of the systems treated in *AAA* and *Schlude* was their tendency to subject government revenues to the uncertainties inherent in prognostications about the rate at which customers would demand services in the future. RCA's system shared this vice.

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[9] This does not mean that the Commissioner abused his discretion in promulgating Rev. Proc. 71-21 and Rev.Rul. 71-299, which permit limited use of the accounting methods upheld by us in *Bressner*. As we point out *infra*, the Commissioner has discretion to permit such methods on the basis of increased experience with them and their effect on revenue collection. We here hold only that *Bressner* was mistakenly decided to the extent that it required the Commissioner to accept a method of accounting that he had discretion to reject.

Although RCA's predictions may have been more accurate than those of the taxpayers in *AAA* and *Schlude*, they were predictions nonetheless, and the Commissioner was not required to accept them as determinants of the federal revenue.

RCA's other arguments on this score require but brief discussion. While the Commissioner has permitted certain forms of accrual accounting in Rev.Proc. 71-21, *supra*, and Rev.Rul. 71-299, *supra*, that does not necessarily mean, as RCA asserts, that the Commissioner has conceded the correctness of RCA's position in this litigation. As we have emphasized above, the Commissioner possesses considerable discretion in these matters, and he was at liberty to alter his stance toward the accounting practices at issue here in light of his greater experience with them and their effect on revenue collection. In addition, although the district court found that RCA's accounting practices did "clearly reflect income," we are not bound by that finding under the "clearly erroneous" standard of Fed.R.Civ.P. 52. The issue before the district court was not whether RCA's accounting method adequately reflected income, but whether the Commissioner abused his discretion in determining that it did not. The latter question is one of law, and for the reasons stated above we conclude that the Commissioner did not abuse his discretion.[10]

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[10] In view of our disposition of this issue, we do not address the government's argument that, absent express legislative authorization and the Commissioner's consent, deferring recognition of income items in accordance with the principles of accrual accounting is never permissible.

Opinion of the United States Court of Appeals, entered on November 13, 1981

III

As an alternate ground for its ruling in favor of RCA, the district court held that Treas.Reg. § 1-381(c)(4)-1(e), *see* note 8, *supra*, which governs the resolution of certain tax accounting problems that may arise in corporate mergers, barred the Commissioner from challenging RCA's adoption of its accrual method of accounting after the liquidation of RCAS in 1957. Section 381(c)(4) of the Internal Revenue Code provides that a corporation that acquires another corporation "shall use the method of accounting used by" the acquired corporation "unless different methods were used" by the two corporations, in which case the acquiring corporation is to use the method required by regulations to be prescribed by the Secretary of the Treasury. At it happened, the Secretary did not prescribe such regulations until 1964, some ten years after 381 was enacted. The 1964 regulations contained certain "Special Rules" applicable to pre-1964 transactions, one of which provided that "this section does not authorize the Commissioner . . . to change any method . . . of accounting" adopted by an acquiring corporation in connection with an acquisition made in a taxable year on which the statute of limitations had expired. Treas.Reg. § 1-381(c)(4)-1(e)(1). Reasoning that RCA and RCAS had employed "different methods" of accounting for prepaid service contract income prior to their merger in 1957, a year on which the statute of limitations had run, the district court held that the Special Rules precluded the Commissioner from challenging RCA's adoption of its accrual method.

We believe the district court erred; we conclude that RCA stands outside the protection of the Special Rules because its method of accounting did not differ from that

of RCAS within the meaning of § 381(c)(4). Regulations promulgated under I.R.C. § 446 define the term "method of accounting" to include "not only the overall method of accounting of the taxpayer but also the accounting treatment of any item." Treas.Reg. § 1-446-1(a) (1960). Given this definition, we must read I.R.C. § 381(c)(4) to require an acquiring corporation to retain an acquired firm's method of accounting with respect to every discrete item of income that the acquired firm received, unless the acquiring firm used a different method with respect to that item. Prior to the 1957 liquidation of RCAS into RCA, the service business was conducted only by RCAS, and RCA did not have service contract income. Until the liquidation therefore, RCA did not have a method of accounting for prepaid service contract income, and it could not have had a method "different" from RCAS's. Accordingly, I.R.C. § 381(c)(4) required RCA to report service contract income on a cash basis, as RCAS had done.

We disagree with RCA's contention that the premised Special Rules are not expressly on the existence of any difference and that in accounting methods, they should be construed to protect not only taxpayers who were uncertain of which method to adopt in the face of a clear conflict between methods, but also those who were uncertain about whether their accounting methods in fact differed from those of an acquired company.[11] Section 381(c)(4) requires

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[11] We are not convinced that there was any valid basis for the uncertainty RCA claims. The regulation providing that the term "method of accounting" referred to treatments of discrete items was not new to the 1954 Code. A regulation adopted under the 1939 Code stated as follows:

> For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions . . .

that a taxpayer use a method of accounting prescribed by regulations thereunder only if its method of accounting differed from that of the acquired company. The regulations under § 381(c)(4), of which the Special Rules are a part, by their terms do not purport to apply to taxpayers who have acquired companies not using a different method of accounting. Treas.Reg. § 1-381(c)(4)-1(a). We therefore find the Special Rules irrelevant.

Finally, we conclude that we need not decide whether Rev.Proc. Rev.Rul. 71-299 are retroactive. Both require the taxpayer to obtain the Commissioner's consent before employing the accounting procedures permissible under them. Rev.Proc. 71-21 at § 5.01.[12] RCA has neither sought nor obtained the Commissioner's consent to adopt those procedures. Accordingly, it may not use them even if the Procedure and Ruling are retroactive.

IV

For the reasons stated above, we reverse the judgment of the district court and remand the matter with instructions to dismiss the complaint.

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[12] Section 5.01 provides:

> Any change by a taxpayer from his present method of including amounts in gross income to the method prescribed in section 3.02 of this Revenue Procedure is a change in method of accounting to which section 446 . . . appl[ies].

Section 446(e), quoted in full at note 4, *supra*, provides that a taxpayer wishing to change his accounting method must obtain the consent of the Secretary of the Treasury.

Judgment of the United States Court of Appeals, entered on November 13, 1981

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 80-6240

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the thirteenth day of November, one thousand nine hundred and eighty-one.

Present:

HON. WILFRED FEINBERG, *Chief Judge*
HON. WALTER R. MANSFIELD
HON. AMALYA L. KEARSE, *Circuit Judges.*

RCA CORPORATION,

Plaintiff-Appellee,

v.

UNITED STATES OF AMERICA,

Defendant-Appellant.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

Judgment of the United States Court of Appeals, entered on November 13, 1981

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is reversed and the action be and it hereby is remanded to the said district court for further proceedings in accordance with the opinion of this court with costs to be taxed against the appellee.

A. Daniel Fusaro
Clerk

By Edward J. Guardaro
Deputy Clerk

Judgment entered 1/12/82.
Raymond F. Burghardt
Clerk

A true copy

A. Daniel Fusaro
Clerk

By Francis X. Gindhart
Chief Deputy Clerk

Judgment of the United States District Court, Southern District of New York, entered and filed September 25, 1980

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

69 Civ. 2633 (MEL)

RCA CORPORATION,

Plaintiff,

—against—

UNITED STATES OF AMERICA,

Defendant.

The issues in the above entitled action having been brought on for trial, before the Honorable Morris F. Lasker, United States District Judge, on March 8, 1979, and upon consideration of the evidence adduced at trial and the Stipulation of Facts entered into by the parties, the Court having on August 13, 1980 handed down its opinion, filed on August 14, 1980; now, therefore, it is hereby

ORDERED, ADJUDGED AND DECREED that plaintiff shall recover from the defendant income taxes overpaid for the 1958 tax year in the sum of $4,627,436.59 and assessed interest overpaid on said tax in the sum of $1,833,046.34, for a total of $6,460,482.93, plus statutory interest thereon pursuant to 28 U.S.C. § 2411 and 26 U.S.C. §§ 6611 and 6621 from November 1, 1965, the date of said overpayments, to a date preceding the date of the refund check by not more than thirty (30) days, such date to be deter-

Judgment of the United States District Court, Southern District of New York, entered and filed September 25, 1982

mined by the Secretary of the Treasury or his delegate; it is further

ORDERED, ADJUDGED AND DECREED that plaintiff shall recover from the defendant income taxes overpaid for the 1959 tax year in the sum of $1,266,289.42 plus statutory interest thereon pursuant to 28 U.S.C. § 2411 and 26 U.S.C. §§ 6611 and 6621 from June 15, 1960, the date of said overpayments, to a date preceding the date of the refund check by not more than thirty (30) days, such date to be determined by the Secretary of the Treasury or his delegate; and it is further

ORDERED, ADJUDGED AND DECREED that plaintiff shall recover from the defendant income taxes overpaid for the 1959 tax year in the sum of $62,313.24 and assessed interest overpaid on said tax in the sum of $22,606.90, for a total of $84,920.14, plus statutory interest thereon pursuant to 28 U.S.C. § 2411 and 26 U.S.C. §§ 6611 and 6621 from April 8, 1966, the date of said overpayments, to a date preceding the date of the refund check by not more than thirty (30) days, such date to be determined by the Secretary of the Treasury or his delegate.

Dated: New York, New York
September 25, 1980

/s/ MORRIS E. LASKER
United States District Judge

Judgment entered this
25th day of September, 1980.

RAYMOND F. BURGHARDT
Clerk

Opinion of the United States District Court, Southern District of New York, filed August 14, 1980

UNITED STATES DISTRICT COURT

S. D. New York

No. 69—Civ. 2633

RCA Corporation,

Plaintiff,

v.

United States of America,

Defendant.

Aug. 14, 1980

Cahill Gordon & Reindel, New York City, for plaintiff; Walter C. Cliff, George Wailand, James S. Kaplan, New York City, of counsel.

John S. Martin, Jr., U. S. Atty. for the Southern District of New York, New York City, for defendant; William G. Ballaine, Asst. U.S. Atty., New York City, of counsel.

Lasker, District Judge.

RCA Corporation ("RCA") sues for a refund of nearly $6,000,000 of federal income taxes it paid for 1958 and 1959, plus deficiency interest paid and interest accrued on these amounts. After lengthy but unsuccessful efforts to negotiate a settlement, as well as time-consuming meetings to reach agreement on the facts, the parties executed a comprehensive stipulation of facts. At trial, RCA presented the testimony of an accounting expert who was the sole

witness. This memorandum embodies the court's conclusions of law, based on the stipulated facts and testimony.

At issue is the extent to which a taxpayer may properly rely on the accrual method of accounting in computing its income for tax purposes. The case involves service contracts made in 1958 and 1959 between RCA and purchasers of new television sets. Under those contracts, the purchaser generally paid RCA a lump sum at the time of purchase, and, in return, RCA agreed to service the television anytime trouble developed over a specified period of from three to twenty-four months. Prior to 1958, such contracts were offered by RCA Service Company, Inc. ("RCAS"), a wholly owned subsidiary of RCA, which was merged into RCA on December 31, 1957, and subsequently operated as a separate corporate division.

Both RCAS and RCA kept their books on an accrual basis. The amounts received from the sale of service contracts were initially divided between that portion to be treated as revenue immediately, which covered the costs of selling and processing the contract, plus a profit, and that portion to be treated as unearned revenue, which was credited to a reserve account. Each month throughout the life of the contract a portion of this reserve was credited to revenue, based on statistically derived schedules designed to take into account as revenue each month that portion of prepaid service contract receipts attributable to the services performed that month under such contracts. This scheme was intended to ensure that such receipts were treated as revenue from month to month only in proportion to related expenses incurred, and thus that RCA's income—the difference between its revenues and expenses—was accurately reflected in its books.

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In computing its 1958 and 1959 income for tax purposes, RCA employed the same method of accounting that it used in keeping its own books. Thus, in reporting its income for those years for tax purposes, RCA only included in income those portions of the amounts received each year from the sale of service contracts that were treated as immediate revenue attributed to the administrative costs of selling the contracts, or attributed, according to RCA's calculations, to services performed during that year. The remainder of the amounts received each year from the sale of service contracts was not included in income for that year, but carried over as a reserve and included in income for subsequent years.

In auditing RCA's returns for 1958 and 1959, the Commissioner concluded that RCA's method of spreading the recognition as revenue of prepaid service contract receipts over the life of the contracts did not "clearly reflect income," as required under I.R.C. § 446(a). Invoking his authority under I.R.C. § 446(b), the Commissioner treated RCA's prepaid receipts as revenue in the year received, and recomputed RCA's taxes on that basis. RCA paid the assessments, then commenced this suit to recover them.

The mechanics of RCA's method for accruing prepaid service contract revenue are set forth fully in the stipulation of facts. Briefly stated, RCA treated all contracts of a particular length entered into during a particular month as a single category. Drawing on its past experience, RCA developed statistical estimates of the percentage of all the service calls expected to be made under contracts of a particular category that would be made during each month of those contracts' term. These estimates were aggregate figures: RCA did not purport to predict when individual

televisions covered by contract within a given category would require service, but only the incidence of service calls under such contracts. RCA continuously refined these estimates in light of its continuing experience.

These estimates of relative monthly service call volume provided the basis for RCA's monthly allocation to revenue of a portion of its receipts from the sale of contracts in each category, and ultimately for the recognition of those receipts as revenue in tax years other than that in which they were received. For instance, RCA's projections indicated that 4.33% of all service calls that would be required under all one-year service contracts entered into in September, 1959, would be made in September of that year, 9.08% in October, 7.87% in November, and 8.71% in December. The remaining service calls would all occur during the first nine months of 1960. Consequently, for tax purposes RCA treated as revenue in 1959 (in addition to the amounts treated as immediate revenue attributable to the costs of selling and processing contracts) only 29.96% of the amounts it received in September, 1959 from the sale of one year service contracts. The remainder would have been treated as revenue in 1960, had the Commissioner not intervened and insisted that RCA treat all amounts received in 1959 as revenue in 1959.

RCA contends that its accrual method of accounting did "clearly reflect income," and consequently that the Commissioner lacked authority under the Code to require RCA to adopt a different method. Alternatively, RCA argues that it is entitled to a refund of about 75% of the assessments it paid because a Revenue Procedure, Rev.Proc. 71-21, 1971-2 C.B. 549, and related Revenue Ruling, Rev.Rul. 71-299, 1971-2 C.B. 218, promulgated by the Commissioner

in 1971, which permit a limited use of accounting procedures like that employed by RCA in 1958 and 1959, are retroactive in effect.

The Government responds, first, that it was within the Commissioner's discretion to find that RCA's accounting method did not "clearly reflect income," and therefore to require RCA to use a different method; second, that the Revenue Procedure and Revenue Ruling on which RCA relies do not have retroactive effect; and third, that in any event RCA is not entitled to a refund for taxes paid in 1958 and 1959 because RCA was required to, but did not, obtain the consent of the Commissioner before employing its accrual method in computing its income for tax purposes, since RCAS had never done so. *See* I.R.C. § 381(c)(4).

I.

Prior to 1916, the Revenue Acts recognized only the "cash receipts and disbursements" method of accounting. However, in the Revenue Act of 1916 Congress provided that a corporate taxpayer that kept its books on some basis other than actual receipts and disbursements could report its income on the same basis, "unless such other basis does not clearly reflect its income." Revenue Act of 1916, c. 463, § 13(d), 39 Stat. 756. The purpose of the new provision

> "was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period."

United States v. *Anderson*, 269 U.S. 422, 440, 46 S.Ct. 131, 134, 70 L.Ed. 347 (1926). This provision of the 1916 Act is reflected today in section 446 of the Internal Revenue Code of 1954, which provides:

> "(a) General Rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.
>
> (b) Exceptions.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.
>
> (c) Permissible methods.—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—
>
> (1) the cash receipts and disbursements method;
>
> (2) an accrual method; . . . ."

The first and principal question to be resolved here is whether the accrual method of accounting, as implemented by RCA, "clearly reflects income" within the meaning of section 446(a).[1]

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[1] The role of accrual accounting in the tax context was succinctly described in *Mooney Aircraft, Inc.* v. *United States*, 420 F.2d 400 (5th Cir. 1969):

> " 'Income' has been defined as 'a net or resultant determined by matching revenues with related expenses.' Since the Internal Revenue Code allows the deduction of substantially all

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A.

The Government relies principally on a trilogy of decisions of the United States Supreme Court: *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 77 S.Ct. 707, 1 L.Ed.2d 746 (1957), *American Automobile Association* v. *United States*, 367 U.S. 687, 81 S.Ct. 1727, 6 L.Ed.2d 1109 (1961), and *Schlude* v. *Commissioner*, 372 U.S. 128, 83 S.Ct. 601, 9 L.Ed.2d 633 (1963). In each of these cases the Court upheld the Commissioner's determination that the accrual method of accounting used by the taxpayer did not clearly reflect income; the Government argues here

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business expenses it seems reasonably clear that Congress intended to tax only net business income. This objective, however, is complicated by the fact that the tax is exacted on an annual basis whereas business transactions are often spread over two or more years. A business may receive payment for goods or services in one tax year but incur the related expenses in subsequent tax years. The result is that the expenses cannot be used to offset the receipts, and the full amount of the receipts is taxed as though it were all net 'profit.'

The purpose of 'accrual' accounting in the taxation context is to try to alleviate this problem by matching, in the same taxable year, revenues with the expenses incurred in producing those revenues. Accurate matching of expenses against revenues in the same taxable year may occur either by 'deferring' receipts until such time as the related expenses are incurred or by 'accruing' estimated future expenses so as to offset revenue. Under the deferral concept present receipts are not recognized as 'income' until they are 'earned' by performing the related services or delivering goods. It is thus not the actual receipt but the *right* to receive which is controlling; and, from an accounting (if not from a tax) point of view, that 'right' does not arise until the money is 'earned.' A corresponding principle states that expenses are to be reported in the year the related income is 'earned' whether or not actually paid in that year."

Id. at 402-03 (footnotes omitted).

that together they establish that the Commissioner may reject the use, for tax purposes, of any accounting method which defers until subsequent tax years the inclusion in gross income of payments received for services to be rendered at unspecified dates in the future.

In the first case in the trilogy, *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 77 S.Ct. 707, 1 L.Ed.2d 746 (1957) (*"Michigan"*), the automobile club provided a variety of services to its members, at their request, such as road maps and highway repairs. Membership dues were collected annually, in advance. On its books, the club recorded one-twelfth of each dues payment as revenue each month of the membership year. For tax purposes, it reported its gross income as recorded on its books. Thus, it did not include the full amount of each dues payment in its gross income for the tax year in which it was received. Instead dues payments were split, one portion included in gross income for the tax year of receipt, the remainder in gross income for the following tax year, in proportion to the number of months of the membership year which fell within each tax year. The Court, holding that this method of accounting did not clearly reflect income, expressed its rationale in a single sentence:

> "The pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member."

Id. at 189. In a footnote, the Court distinguished *Beacon Publishing Co.* v. *Commissioner*, 218 F.2d 697 (10th Cir. 1955), in which it was held that the Commissioner exceeded

his authority in requiring the taxpayer to treat sums received for prepaid newspaper subscriptions as revenue during the year they were received, rather than over the life of the subscriptions, and *Schuessler* v. *Commissioner*, 230 F.2d 722 (5th Cir. 1956), in which the court rejected the Commissioner's attempt to require the taxpayer to treat as revenue during the year received that portion of receipts from the sale of gas furnaces which was properly attributable to the taxpayer's contractual obligation to turn the furnaces on and off each year for five years:

> "In *Beacon*, performance of the subscription, in most instances, was, in part, necessarily deferred until the publication dates after the tax year. In *Schuessler*, performance of the service agreement required the taxpayer to furnish services at specified times in years subsequent to the tax year. In this case, substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year."

353 U.S. at 189 n.20, 77 S.Ct. at 712 n.20. In many respects, the parties' contrary positions here are reflected in these two quotations. RCA, relying on the statement quoted from the text of the decision, contends that the teachings of this decision and the subsequent decisions in the trilogy is simply that an accounting method that is "purely artificial" is not acceptable, but that a method which can be shown to accurately record related revenues and expenses in the proper accounting period is not. The Government, relying on the quotation from the footnote, argues that the Commissioner may reject any method for deferring

recognition of receipts as revenue, no matter how accurately it matches revenues and expenses, if "the contract revenues in question are tied to future services to be performed without relation to fixed dates in the future." We conclude that RCA's position is the correct one. In our view, the subsequent decisions of the Supreme Court establish that the fact that the services paid for are not to be performed on fixed dates is not in and of itself determinative, but is significant only insofar as it throws light on the question whether the challenged accounting method is "artificial" because it fails adequately to ensure that receipts are included in gross income in any tax year only in proportion to related expenses incurred during that year.

Two years after the Supreme Court's decision in *Michigan*, the Second Circuit, in *Bressner Radio, Inc.* v. *Commissioner*, 267 F.2d 520 (2d Cir. 1959), *nonacq.*, Rev.Rul. 60-85, 1960-1 C.B. 181 (1960), adopted the interpretation of *Michigan* which RCA urges here. The facts in *Bressner* were virtually identical to those of the case at hand: Like RCA, Bressner sold televisions and entered into written contracts to service them. Bressner's service contracts, unlike RCA's, covered initial installation as well as service, and were available for a twelve month term only. Bressner received between $80 and $100 for each contract, the initial cost of installation was approximately $19, and Bressner's experience showed that an average of 8 to 12 service calls would be made during the term of each contract. Accordingly, Bressner treated 25% of the contract price as revenue at time it was received, to cover the costs of installation, and "deferred the balance over the twelve month period of the contract." *Id.* at 521. The Second Circuit found that this method of accounting did clearly

reflect income, that the method which the Commissioner sought to substitute for it (which is similar to the method the Commissioner employed here in recomputing RCA's income for 1958 and 1959) and grossly distorted income, and held that the Commissioner overstepped his authority in rejecting Bressner's method in favor of his own.

Distinguishing the Supreme Court's decision in *Michigan,* the Second Circuit stated:

> "It is apparent from the decision of the majority that at least for purposes of the decision of the case it assumed that a realistic deferral would have been permissible, and found only that no realistic deferral was made. . . . The majority appears to have proceeded from an assumption that accrual accounting would be acceptable tax practice."

Id. at 526-27. The court found that unlike the taxpayer in *Michigan,* Bressner had proven that its deferral method was "realistic":

> "There is nothing apparently artificial about the petitioner's method of deferral here. Drawing on its experience with thousands of contracts it has demonstrated that it was subjected to a reasonably uniform demand for services, so that it could and did anticipate that the expenses incident to the performance which alone would entitle it to regard the sum received as earned would be distributed across the life of the contract. It therefore deferred revenues until they were earned, and thus matched them with foreseeably related expenses, which is the essential purpose of accrual accounting."

Id. at 528. It is clear that if *Bressner* were the last word on the issue, RCA would prevail here. The question, however, is whether subsequent decisions of the Supreme Court have limited or overruled *Bressner*, and if so to what extent.

The second decision in the trilogy is *American Automobile Association* v. *United States*, 367 U.S. 687, 81 S.Ct. 1727, 6 L.Ed.2d 1109 (1961) (*"AAA"*). There the taxpayer, also an automobile club, had accounted for membership dues using the same method as the taxpayer in *Michigan*—that is, it had recorded dues as revenue on its books ratably over the twelve month membership period, thereby including dues payments in its gross income each tax year only to the extent that that tax year coincided with the membership period. However, in *AAA* the taxpayer presented

> "expert accounting testimony indicating that the system used was in accord with generally accepted accounting principles; that its proof of cost of member service was detailed; and that the correlation between that cost and the period of time over which the dues were credited as income was shown and justified by proof of experience."

Id. at 691, 81 S.Ct. at 1729. Relying on this testimony, the taxpayer argued that it had demonstrated that its method of deferring the recognition of revenue ratably was not "artificial."

The Court of Claims rejected this argument, and the Supreme Court, "[r]ecognizing a conflict between the decision below and that in *Bressner Radio, Inc.* v. *Commissioner*," *id.* at 689, 81 S.Ct. at 1728, granted certiorari.

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In affirming the Court of Claims' decision on remand, the Court relied on its earlier decision in *Michigan*, stating that its earlier holding,

> "that the system of accounting was 'purely artificial[,]' was based upon the finding that 'substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year.' "

Id. (quoting 353 U.S. at 189 n.20, 77 S.Ct. at 712 n.20). Responding to the taxpayer's argument that the proof at trial established that in the aggregate it provided services to its members evenly throughout the year (despite the fact that it was impossible to know beforehand when any *individual* member would seek services), and therefore that it was justified in recognizing membership dues as revenue ratably over the membership year, the Court remarked:

> "[O]ther findings merely reflecting statistical computations of average monthly cost per member on a group or pool basis are without determinate significance to our decision that the federal revenue cannot, without legislative consent and over objection of the Commissioner, be made to depend upon average experience in rendering performance and turning a profit. Indeed, such tabulations themselves demonstrate the inadequacy from an income tax standpoint of the *pro rata* method of allocating each year's membership dues in equal monthly installments not in fact related to the expenses incurred. Not only did individually incurred expenses actually vary from month to month, but even

> the average expenses varied-recognition of income nonetheless remaining ratably constant."

Id. at 693, 81 S.Ct. at 1730.[2]

It would be less than candid to say that we do not find this passage to be cryptic. While it appears to reject out of hand the use of "statistical computations" made on a "group or pool basis" in computing income for tax purposes, it provides as a rationale for doing so only the observation that the taxpayer's pro rata deferral method did not in fact accurately match revenues and expenses. If read broadly as a blanket proscription of the use of statistical computations of average cost "on a group or pool basis," it presents a formidable hurdle to RCA's recovery in this case. We believe, however, that in view of its opacity, and in the light of subsequent decisions, the passage should be more narrowly construed. Indeed, shortly after the decision in *AAA*, the Second Circuit went out of its way to state its conclusion that the Supreme Court's decision in no way impaired the vitality of *Bressner*, a case in which deferral was allowed based on "the taxpayer's statistics show[ing] a definite monthly business

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[2] The Court continued:

> "Although the findings below seem to indicate that it would produce substantially the same result as that of the system employed, we consider similarly unsatisfactorily, from an income tax standpoint, allocation of monthly dues to gross monthly income to the extent of *actual* service expenditures for the same month computed on a group or pool basis."

AAA, 367 U.S. at 693, 81 S.Ct. at 1730 (emphasis added). This sentence presaged the Court's subsequent analysis in the third case in the trilogy, *Schlude* v. *Commissioner*, 372 U.S. 128, 83 S.Ct. 601, 9 L.Ed.2d 633 (1963), *discussed infra*.

experience and financial expectancy." *Automobile Club of New York*, 304 F.2d 781, 784 (2d Cir. 1962).

This brings us to the third decision of the trilogy, *Schlude* v. *Commissioner*, 372 U.S. 128, 83 S.Ct. 601, 9 L.Ed.2d 633 (1963). In this case, the taxpayers had prevailed in the Court of Appeals, which rendered its decision prior to the Supreme Court's decision in *AAA*. On the Commissioner's appeal to the Supreme Court, the case was remanded for further consideration in light of *AAA*, and the Court of Appeals reversed its position and upheld the Commissioner. The Supreme Court "brought the case back once again to consider whether the lower court misapprehended the scope of" *AAA*, *id.* at 130, 83 S.Ct. at 602, which may indicate that *AAA* may not cut so wide a swath as its broad language would suggest. Though the Court did affirm the Court of Appeals' determination that the accrual method employed by the taxpayers in *Schlude* did not "clearly reflect income," this does not, in view of the facts in *Schlude*, necessarily indicate that the Court endorsed a broad reading of *AAA*. To the contrary, we believe that *Schlude*, by implication, narrowed the scope of *AAA*.

The taxpayers in *Schlude*, who operated dance studios, sold contracts for specified numbers of hours of dance lessons, ranging from five to 1,200. The contracts specified the period during which the lessons had to be taken, but the actual dates of lessons were arranged from time to time as they were taken. Under the contracts, the student was obliged to pay the full contract price whether or not any or all of the lessons were actually taken. The Court summarized the taxpayers' method of accounting for the amounts received under these contracts as follows:

> "When a contract was entered into, a 'deferred income' account was credited for the total contract price. At the close of each fiscal period, the student record cards were analysed and the total number of taught hours was multiplied by the designated rate per hour of each contract. The resulting sum was deducted from the deferred income account and reported as earned income on the financial statements and the income tax return. In addition, if there had been no activity in a contract for over a year, or if a course were reduced in amount, an entry would be made canceling the untaught portion of the contract, removing that amount from the deferred income account, and recognizing gain to the extent that the deferred income exceeded the balance due on the contract, *i. e.*, the amounts received in advance. . . . The balance of the deferred income account would be carried forward into the next fiscal year to be increased or decreased in accordance with the number of new contracts, lessons taught and cancellations recognized."

Id. at 131-32, 83 S.Ct. at 603. The Court held that it was proper for the Commissioner to reject this method of accounting as not clearly reflecting income, finding the question "squarely controlled" by *AAA*. The Court concluded that the system employed by the taxpayers suffered from the same vice as the systems disallowed in *Michigan* and *AAA*, "since the advance payments related to services which were to be performed only upon customers' demands without relation to fixed dates in the future." The Court's analysis, however, establishes that this fact was significant only because it ensured that the accounting method the

taxpayers employed could not accurately match revenues and related expenses:

> "[T]he studio sought to defer its cash receipts on the basis of contracts which did not provide for lessons on fixed dates after the taxable year, but left such dates to be arranged from time to time by the instructor and his student. Under the contracts, the student could arrange for some or all of the additional lessons or could simply allow their rights under the contracts to lapse. But even though the student did not demand the remaining lessons, the contracts permitted the studio to insist upon payment in accordance with the obligations undertaken and to retain whatever prepayments were made without restriction as to use and without obligation of refund. *At the end of each period, while the number of lessons taught had been meticulously reflected, the studio was uncertain whether none, some or all of the remaining lessons would be rendered.*"

Id. at 135-36, 83 S.Ct. at 605 (emphasis added). In a footnote, the Court further explained its reasoning:

> "The treatment of 'gains from cancellations' underlines this aspect of the case. These gains, representing amounts paid or promised in advance of lessons given, were recognized in those periods in which the taxpayers arbitrarily decided the contracts were to be deemed canceled. *The studio made no attempt to report estimated cancellations in the year of receipt, choosing instead to defer these gains to periods bearing no economic relationship to the income recognized.*"

Id. at 136 n. 9, 83 S.Ct. at 605 (emphasis added). In light of these passages, it appears that what the Court found "artificial," and therefore impermissible, about the taxpayers' method of accounting for advance payments related to services to be performed "only upon customers' demand without relation to fixed dates in the future" was not that the *time* of performance was not specified, but rather that the *extent* of performance was not specified, and consequently there was no assurance that including receipts in gross income to the extent of *actual* expenses incurred each year was equivalent to including receipts in gross income in proportion to that year's share of total expenses to be incurred over the life of the contract. As the dissent in *Schlude* points out, this inadequacy could be remedied only through the use of statistical projections of anticipated expenses not unlike those employed by RCA here. And, as the dissenting opinion further indicates, the majority's reference to the use of "estimated cancellations" as the cure for the defect dispels any suggestion that the broad but cryptic language used by the Court in *AAA* was intended to bar the use of such projections, provided they are adequately supported. *See id.* at 142, 83 S.Ct. at 608 (Stewart, J., dissenting).

A similar view of the trilogy was adopted in *Mooney Aircraft, Inc.* v. *United States*, 420 F.2d 400 (5th Cir. 1970). There the court rejected the position which the Government takes here:

> "The Government argues that *Schlude* and *AAA* require that [the cost of performing prepaid services] must arise on fixed dates. But we think that the relevance of the 'fixed dates' criteria in *Schlude* and *AAA* was that since there were no fixed dates on which ser-

> vices had to be performed, there was no assurance that services *would be performed* after the tax year. . . . All that *Schlude* and *AAA* would seem to require is that the deferred income is reported as the related costs do in fact occur."

Id. at 407-08 (emphasis in original). Though in *Mooney* the court nonetheless concluded that the taxpayer was not entitled to defer the recognition of revenues for 15, 20, or 30 years until the related expenditure occurred, it did so only because the inordinate length of time involved completely attenuated the relationship between receipt and expenditure and lessened the probability that the expenditure would in fact be paid. *Id.* at 409-10.

Other lower court decisions are not to the contrary. In *Artnell Co.* v. *Commissioner*, 400 F.2d 981 (7th Cir. 1968), *Boise Cascade Corp.* v. *United States*, 530 F.2d 1367 (Ct. Cl.) *cert. denied*, 429 U.S. 867, 97 S.Ct. 176, 50 L.Ed.2d 147 (1976), and *Morgan Guaranty Trust Co.* v. *United States*, 585 F.2d 988 (Ct.Cl. 1978), the courts ruled that the taxpayer was entitled to defer recognition of revenue, although in each case the services involved were to be performed on fixed dates. In *Hagen Advertising Displays, Inc.* v. *Commissioner*, 407 F.2d 1105 (6th Cir. 1969), the court ruled that the taxpayer was not entitled to defer the recognition of revenue, but there the taxpayer, which was paid in advance to manufacture advertising signs to be delivered in subsequent tax years, treated the advance payments as revenue *only* in the year the signs were delivered, even though it often started work on them as soon as it received an order.

In our view, the teachings of the trilogy can be briefly summarized as follows: *Michigan* and *AAA* establish that a taxpayer may not simply prorate recognition of receipts as revenue over the period in which the service covered by those receipts is to be rendered, because there is no assurance that those services will be rendered ratably over that period. *Schlude*, on the other hand, establishes that a taxpayer may not, automatically each year, recognize revenue to the extent of *actual* expenses incurred that year, because there is no assurance that this amount will accurately reflect the portion of the total expenses to be incurred under the contract attributable to that year. In each of these cases the Court found the taxpayers' method of accounting for prepaid receipts "artificial" not, as the Government contends here, because those receipts related to services to be performed at unspecified times in tax years subsequent to that of their receipt, but rather, as RCA argues, because in each case the taxpayers' accounting method failed to account properly for that fact through the use of adequately supported statistical projections.

As *Schlude* makes clear, the use of such projections is essential to any system of accounting on an accrual basis for prepaid revenues covering services to be performed at unspecified times. The Government argues, however, that such projections may not be used in computing income for tax purposes. It relies heavily on the suggestion in *AAA* that "the federal revenue cannot, without legislative consent and over objection of the Commissioner, be made to depend upon average experience in rendering performance and turning a profit," 367 U.S. at 693, 81 S.Ct. at 1730, and seeks to bolster this suggestion by reference to the following passage from the Supreme Court's recent decision in

Thor Power Tool Co. v. *Commissioner*, 439 U.S. 522, 543, 99 S.Ct. 773, 786, 58 L.Ed.2d 785 (1979):

> "The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. . . . This difference in objectives is mirrored in numerous differences of treatment. . . . Financial accounting, in short, is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty."

Id. at 542-43, 99 S.Ct. at 786-87.

We find the Government's position unpersuasive. As indicated above, the language the Court used in *AAA* is far from clear, and must be read in light of the Court's subsequent statements in *Schlude*. And while it is true that in *Thor* the Court indicated that the Commissioner, because of his duty to protect the public fisc, must give less quarter to "estimates, probabilities, and reasonable certainties" then a financial accountant may or ought to, the thrust of *Thor* is that a taxpayer's method of accounting must be justified by hard evidence, *including statistical evidence*, *see id.* at 527, 99 S.Ct. at 778 (criticizing the taxpayer for failing to present "statistical evidence justifying its system for writing down inventory), rather than assumptions based on "general business experience," or "well-educated

guesses." In our view, a taxpayer is entitled to rely on reliable statistical projections of anticipated expenses in determining the extent to which prepaid amounts should be included in gross income in tax years other than that of their receipt, in accordance with the principles of accrual accounting.

Accordingly, we conclude that the Commissioner is not authorized to reject a deferral method of accounting *simply* because the deferred revenues relate to services to be performed at unspecified times in tax years subsequent to that of receipt. Through the use of statistical projections, a taxpayer using a deferral method may achieve a reasonably precise matching of revenues and expenses despite the fact that the actual time services will have to be performed is not known, thereby computing income "according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period." *United States* v. *Anderson, supra,* 269 U.S. at 440, 46 S.Ct. at 134. RCA contends that the method of accounting it used in 1958 and 1959, which was based, unlike those employed by the taxpayers in *Michigan, AAA,* and *Schlude,* on hard statistical data rather than informed hunches, did just that. Assuming that RCA's statistical projections were reliable and properly used, we believe the Commissioner could not require RCA to use a different method of accounting simply because RCA could not know, in advance, when it would be required to provide service under *individual* service contracts.

B.

The Government, however, argues more broadly, in the alternative, that the Commissioner may reject any method

of accounting that defers the inclusion of payments for future services until later tax years, unless that method is expressly authorized by statute. The short answer to this argument is that the accrual method of accounting *is* expressly authorized by statute. The longer answer is that the authorities on which the Government relies do not establish that the Commissioner enjoys the unbridled discretion that the Government's argument would vest in him; the ultimate question remains whether a taxpayer's method of accounting "clearly reflects income."

The premise for the Government's argument on this point is Congress' introduction and subsequent repeal of sections 452 and 462 of the Internal Revenue Code of 1954. Ch. 736, §§ 452, 462, 68A Stat. 3, *repealed*, ch. 143, § 1, 69 Stat. 134 (1955). Section 452, a part of the 1954 Code as originally enacted, authorized deferral practices such as that employed by RCA in preparing its returns for 1958 and 1959. Section 462 authorized similar accrual practices. Both provisions were retroactively repealed one year after the Code was enacted "upon [the] insistence by the Treasury that the proposed endorsement of such tax accounting would have a disastrous impact on the Government's revenue." *AAA*, *supra*, 367 U.S. at 695, 81 S.Ct. at 1731.

In *AAA*, the Court observed:

> "It appears that in this action Congress first overruled the long administrative practice of the Commissioner and holdings of the courts in disallowing such deferral of income for tax purposes and then within a year reversed its own action. The repeal, we believe, confirms our view that the method used by the Association could be rejected by the Commissioner. While the claim is made that Congress did not 'intend to disturb

> prior law as it affected permissible accrual accounting provisions for tax purposes,' H.R.Rep. No. 293, 84th Cong. 1st Sess. 4-5, the cold fact is that it repealed the only law incontestably permitting the practice upon which the Association depends."

Id. at 695, 81 S.Ct. at 1731. In *Schlude* the Court again adverted to Congress' action, noting that in *AAA* the legislature's repeal of

> "'the only law incontestably permitting the practice upon which [the taxpayer] depends,' was regarded as reinstating long-standing administrative and lower court rulings that accounting systems deferring prepaid income could be rejected by the Commissioner."

372 U.S. at 134, 83 S.Ct. at 604. The Government's argument is that the Court's reading of this legislative history demonstrates the Commissioner's authority to reject any method of accounting that does not treat payments received for future services as gross income in the year of receipt.

Although one court may have adopted the position that the government urges here, *see Hagen Advertising Displays, Inc.* v. *Commissioner*, 407 F.2d 1105 (6th Cir. 1969), others have clearly rejected it, *e.g.*, *Boise Cascade Corp.* v. *United States*, 530 F.2d 1367 (Ct.Cl.), *cert. denied*, 429 U.S. 867, 97 S.Ct. 176, 50 L.Ed.2d 147 (1976); *Mooney Aircraft, Inc.* v. *United States*, 420 F.2d 400 (5th Cir. 1970); *Artnell Co.* v. *Commissioner*, 400 F.2d 981 (7th Cir. 1968). We find particularly persuasive the Fifth Circuit's commentary in *Mooney:*

> "This alternative ground, based on legislative intent, would seem to dispose of the entire question: *all* de-

> ferrals and accruals are bad unless specifically authorized by Congress. But the Court was careful to discuss the legislative history as dictum and restricted its holding to a finding that the Commissioner did not abuse his discretion in rejecting the AAA's accounting system. It specifically refrained from overruling *Beacon* and *Schuessler*, distinguishing them on the ground that future performance was certain. It seems, then, that the Court is for the present taking a middle ground pending Congressional reform and clarification in this extremely confused area of the law: While the repeal of §§ 452 and 462 does not absolutely preclude deferrals and accruals, it indicates that the Commissioner should have very broad discretion to disallow such accounting techniques when there is any reasonable basis for his action."

420 F.2d at 408-09 (footnotes and citation omitted). We agree with this analysis. As the Seventh Circuit stated in *Artnell, supra*, 400 F.2d at 985:

> "[T]here must be situations where the deferral technique will so clearly reflect income that the Court will find an abuse of discretion if the Commissioner rejects it."

See Thor Power Tool Co. v. *Commissioner, supra*, 439 U.S. at 533, 99 S.Ct. at 781. The proper test, under the statute, remains whether the accounting method in question "clearly reflects income"—that is, in our view, whether it ensures, with reasonable precision, that deferred revenues are included in gross income in tax years subsequent to that in which they are received only in proportion to

the related services performed, and expenses incurred, during those tax years.

C.

Because we conclude that as a matter of law RCA was entitled to use a deferral method of accounting based on reliable statistical projections in computing its income for tax purposes, so long as that method did "clearly reflect income," and because we conclude, *infra*, that RCA has adequately demonstrated that the method it used in 1958 and 1959 matched revenues and related expenses with such precision that it was beyond the Commissioner's discretion to conclude that that method did not "clearly reflect income," we need not address RCA's alternative argument that it is entitled to a refund because Revenue Procedure 71-21 and Revenue Ruling 71-299 apply retroactively.

These administrative directives reflect the Commissioner's 1971 decision

> "to allow accrual method taxpayers in certain specified and limited circumstances to defer the inclusion in gross income for Federal income tax purposes of payments received (or amounts due and payable) in one taxable year for services to be performed by the end of the next succeeding taxable year."

Rev.Proc. 71-21, § 1, 1971-2 C.B. 549 (1971). Under Revenue Procedure 71-21, a taxpayer who receives advance payment pursuant to an agreement that requires the taxpayer to perform contingent services no later than the end of the tax year following the tax year in which payment is received may defer inclusion of part of the payment in gross income

> (a) on a statistical basis if adequate data are available to the taxpayer; (b) on a straight-line ratable basis over the time period of the agreement if it is not unreasonable to anticipate at the end of the taxable year of receipt that a substantially ratable portion of the services will be performed in the next succeeding taxable year; or (c) by the use of any other basis that in the opinion of the Commissioner, results in a clear reflection of income.

Id. § 3.06. In Revenue Ruling 71-299, 1971-2 C.B. 218 (1971), the Commissioner modified his earlier nonacquiescence in the Second Circuit's decision in *Bressner,* Rev. Rul. 60-85, 1960-1 C.B. 181 (1960), "to the extent inconsistent with Section 3 of Revenue Procedure 71-21."

Although we need not decide whether RCA is entitled to relief under these provisions, it is worth noting that the Government's staunch opposition to RCA's accounting method is undercut at least to some extent by the Commissioner's determination that statistical deferral methods have a place in tax accounting, and will be accepted by the Internal Revenue Service at least in some circumstances, as a proper basis for the computation of income for tax purposes.

II.

The next question is whether RCA's method of accounting for prepaid service contract revenues, as actually applied in 1958 and 1959, achieved its objective of matching revenues and related expenses with precision. We find that it did.

The most telling piece of evidence on this point, as indicated in Exhibit Q to the Stipulation of Facts, which is

reproduced below, is the very high correlation between RCA's monthly net sales from its service business, which consisted principally of service contract revenues included in monthly income on the basis of RCA's statistical projections, and the related direct expenses RCA *actually* incurred during each month of 1958 and 1959. This alone indicates that RCA's accounting method predicted the flux of RCA's service business quite accurately.[3]

[3] Exhibit Q [on the following pages] represents graphically the data set forth in ¶ 39 of the Stipulation of Facts.

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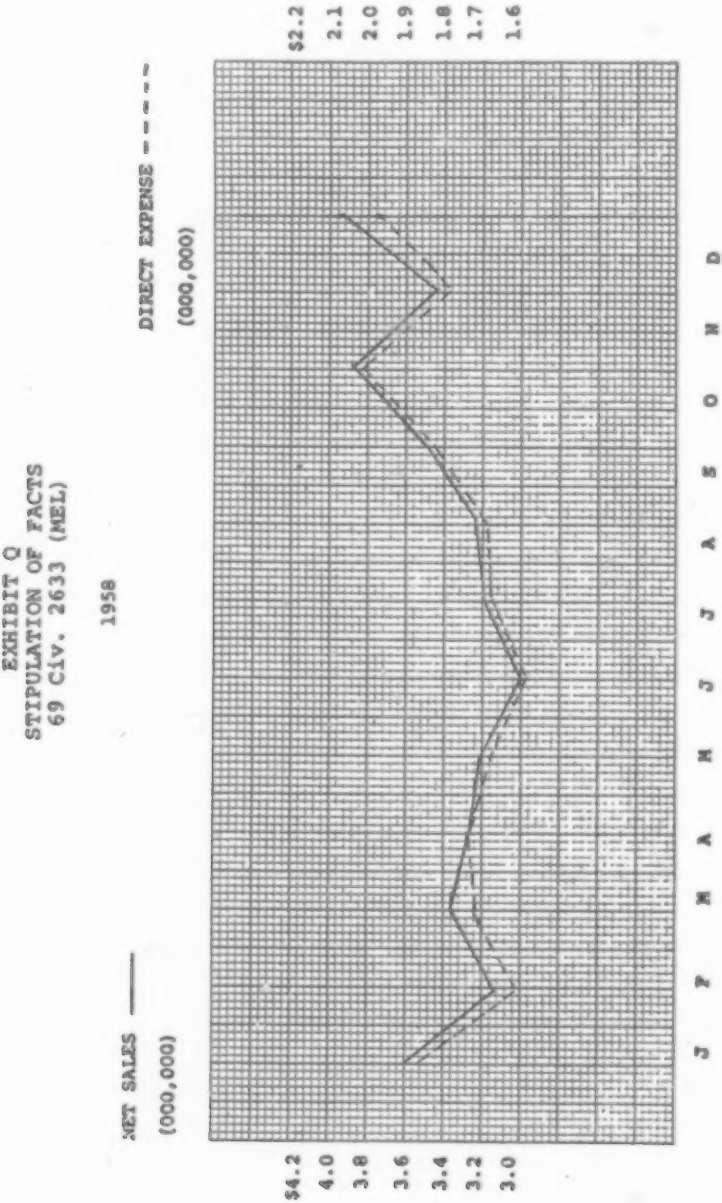

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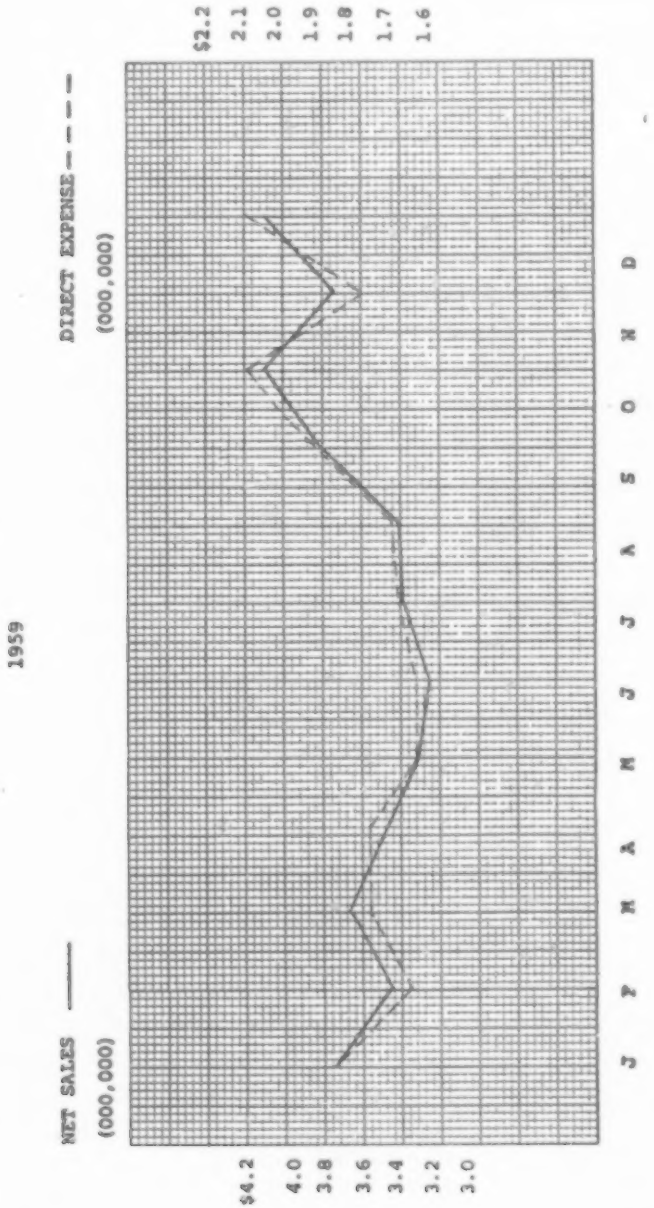

In addition, Charles Gillette, a partner in the accounting firm of Arthur Young & Co. and chair of its Policy Statements Committee, testified that in his opinion the stipulated facts show that RCA's system achieved "a very high degree of precision," [4] and at trial the Government stipulated that "it does accomplish its objective, which is to match all revenues for demand and contract to all expenses for demand and contract services." [5] Nonetheless, the Government contends that RCA has not carried its burden of proving that its system is adequate for tax purposes.

The Government's limited "concession" that RCA's accounting method does "match all revenues for demand and contract to all expenses for demand and contract services" is representative of one class of objections it makes to RCA's use of that method in computing its taxes. Briefly stated, the Government takes the position that to prevail RCA must prove not only that its accounting system *as a whole* works with precision, but also that each component of the system does so. Thus, the Government argues that the statistical projections RCA used in determining what portion of service contract receipts should be included in gross revenue each month were not adequate for that purpose for a number of reasons—because in some cases the projections were based on data reflecting service calls performed on demand as well as service calls performed pursuant to service contracts; because their statistical sophistication varied widely; because they protected service call volume rather than dollar expenses; and because they were not broken down to take account of various options avail-

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[4] Trial Transcript at 53.

[5] *Id.* at 91.

able to the purchasers of RCA's service contracts. These objections are material only if the Government is correct that RCA must prove something more than that its accounting method, as a whole, matched revenues and expenses well. We do not believe the Government is correct: the projections were only intended to, and, in our view of the law, need only, operate in the aggregate. If the evidence shows that the whole package of RCA's projections, as applied in 1958 and 1959, achieved a reasonably precise allocation of revenues to the accounting periods in which related expenses were incurred, it is not significant that some of the projections used were "less scientifically, less precisely determined" than others.[6] Moreover, imprecisions in RCA's *monthly* projections would not necessarily be significant here, since for tax purposes what is controlling is not whether the projections properly matched revenues and expenses from month to month, but whether they did so from year to year.

The Government also asserts that RCA has not proven that the data it used in formulating its statistical projections were accurate. But RCA's after-the-fact demonstration that its projections were valid predictors of its expenses creates a strong presumption that the underlying data was accurate, and the Government has not overcome the presumption. The Government contends only that RCA has failed in its proof—it has not suggested that RCA's data gathering procedures, record keeping, or statistical method were defective in any way, and while it would be remarkable if a project of this scope were completely free from error, the Government has not indicated why any errors that may have cropped up would be material

[6] *See id.* at 69-70.

here. Moreover, some weight must be given to RCA's interest in compiling accurate information, since that information was used to aid management in scheduling and budgeting for monthly labor and materials requirements, as well as in the preparation of RCA's accounts and tax returns. In the circumstances, we do not believe it necessary that RCA, to establish the reliability of its projections, trace the pedigree of its figures to their source—the reports of thousands of daily service calls.

We find that RCA has carried its burden of proving that in practice its accounting theory operated with reasonable precision, and accordingly, we conclude that the Commissioner abused his discretion under section 446 of the Code in requiring RCA to use a different method in computing its taxes.

III.

The deferral method that RCA used in accounting for prepaid service contract revenues for both book and tax purposes was the method that RCAS used, prior to its merger into RCA on December 31, 1957, in keeping its books. It was not, however, the method RCAS used in preparing its tax returns: for tax purposes, RCAS included all amounts received each year from the sale of service contracts in its gross income for that year. The Government argues that even if the method of accounting employed by RCA in 1958 and 1959 did clearly reflect income, RCA's use of that method constituted a change of accounting method which required the Commissioner's consent, and that RCA's failure to obtain that consent bars any refund now.

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The merger of RCAS into RCA was a transaction covered by section 381 of the 1954 Code, which deals with the acquisition of the assets of one corporation by another. Section 381(c)(4) provides:

> "Method of Accounting — The acquiring corporation shall use the method of accounting used by the distributor or transferor corporation on the date of distribution or transfer unless different methods were used by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of computing taxable income adopted pursuant to regulations prescribed by the Secretary."

No regulations under section 381(c)(4) were promulgated until August 5, 1964, ten years after the statute was enacted, and six years after the merger was completed. As a consequence, the regulations contain "Special Rules" for acquisitions, such as that involved here, that occurred before the regulations came into being. Treas.Reg. § 1.381 (c)(4)-1(e) (1964). The Government's position, apparently,[7] is that RCA may not rely on the Special Rules here because it has not proven that at the time of the merger it used a different method of accounting than RCAS, and therefore has not shown that it was entitled

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[7] The parties' briefs, which were filed simultaneously, suggest that neither party fully understood the other's position on the issue discussed in this section of the opinion. Consequently, their respective legal contentions were never fully crystallized.

under section 381(c)(4) to use any method of tax accounting other than that previously used by RCAS.

This position is untenable. On their face, the Special Rules relating to acquisitions occurring prior to August 5, 1964 apply to all such acquisitions, without regard to whether the corporations involved used the same or different methods of accounting at the time of the acquisition. And although this may not conform strictly to the language of section 381(c)(4), it is the only plausible reading of the Special Rules, since prior to the issuance of the regulations on that date there was no way to know definitely under what circumstances the Commissioner would consider the accounting methods of an acquiring and acquired corporation the same or different within the meaning of the statute, and thus no way to know whether the acquiring corporation was required to use the method of accounting previously used by the acquired corporation, or some other method prescribed in as yet non-existent regulations.[8] In our view, whether RCA and RCAS used

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[8] The dilemma faced by RCA at the time of its merger with RCAS is illustrative. The stipulation indicates that prior to the merger, RCA used a deferral method of accounting for sales of coupon books that entitled the purchaser to discounts on future purchases of record albums similar to that which it later employed in accounting for service contract revenues. Although the Government asserts that this evidence is insufficient to establish that at the time of the merger RCA and RCAS used different methods of accounting, it certainly suggests that they treated similar types of receipts differently, and thus that section 381(c)(4) would require RCA, following the merger, to account for service contract revenues "pursuant to regulations prescribed by the Secretary," even though no such regulations existed until 1964. In the existing regulatory vacuum, RCA and other taxpayers facing the same dilemma were left to their own devices. The Special Rules embodied in the regulations when they were finally issued ensure that such taxpayers are not penalized for the accounting decisions they made under such circumstances.

the same or different methods of accounting at the time of their merger is immaterial here; the sole question is whether, under the Special Rules, RCA's decision in 1958 to adopt a method of accounting for prepaid service contract revenues different from that previously employed by RCAS contravened section 381(c)(4) of the Code.

The Government does not dispute that if the Special Rules apply here, RCA's decision is proof against any challenge based on section 381(c)(4). The Special Rules provide that if an acquisition occurred during a tax year of the acquiring corporation for which the statute of limitations has run,

> then this section does not authorize the Commissioner or the acquiring corporation to change any method or methods of accounting in any taxable year of the acquiring corporation. . . .

Id. § 1.381(c)(4)-1(c)(1). Here the acquisition was completed on December 31, 1957, the last day of a tax year for which the statute of limitations has run, and under this section of the Special Rules RCA's method of accounting cannot be changed.[9]

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[9] Even if the merger of RCA and RCAS had occurred during a year for which the statute of limitations had not run, the result would have been the same. The Special Rules provide that if the acquisition occurred during a tax year of the acquiring corporation for which the statute of limitations has not run, and the taxpayer has, for that tax year,

(a) adopted or continued a method of accounting consistent with the rules of this section, (b) been granted permission by the Commissioner in accordance with paragraph (c) of § 1.446-1 to use a method or combination of methods of accounting, or (c) adopted a method of accounting that under other sections of the Internal Revenue Code, or regulations thereunder, may be adopted without the consent of the Commissioner, then the method or methods of

Nothing in the Code or regulations suggests that the refund RCA seeks must be disallowed because RCA did not obtain the consent of the Commissioner before adopting its accrual method of accounting, and we conclude that RCA is not barred from recovery here simply because it adopted a different method of accounting from that used by RCAS prior to their merger.

* * * * * *

In sum, we conclude that RCA's method of accounting, in theory and in practice, clearly reflected its income for 1958 and 1959, and consequently that the Commissioner abused his discretion under section 446 of the Code in

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accounting adopted or continued in the manner described in (a), (b), and (c) shall not be changed, by reason of the rules contained in this section, by the Commissioner or the acquiring corporation for any taxable year ending after the date of distribution or transfer. . . .

Id. 1.381(c)(4)-1(e)(2)(i). If the acquisition occurred during a tax year of the acquiring corporation for which the statute has not run and the taxpayer has, for that tax year,

adopted or continued a method or methods of accounting other than in the manner described in (a), (b), and (c) of subdivision (i) of this subparagraph, then the acquiring corporation may—

(a) Continue to use the method or methods of accounting so adopted or continued if such method or methods clearly reflect income and if proper adjustments were made to reflect the adoption of such method or methods, or

(b) Adopt the method or methods of accounting prescribed by this section. . . .

Id. § 1.381(c)(4)-1(e)(2)(ii). Under these provisions RCA would have been entitled to adopt its method of accounting, since we have found that it does clearly reflect income, either under section 1.381(c)(4)-1(e)(2)(i)(c) of the regulations (if, as RCA argues, section 446 of the Code authorized it to use an accrual method that clearly reflects income without obtaining the Commissioner's consent), or otherwise under section 1.381(c)(4)-1(e)(2)(ii)(a) of the regulations.

requiring RCA to adopt another method of computing its income for tax purposes. Further, under the applicable regulations, RCA was entitled to employ the accounting method it did employ even though RCAS had not previously used that method for tax purposes.

RCA is entitled to refund of the difference between the taxes it actually paid and the taxes it would have paid under its method of accounting, as well as any deficiency interest paid, plus interest.

Submit judgment on notice.

Section 381 of the Code

(a) GENERAL RULE—In the case of the acquisition of assets of a corporation by another corporation—

(1) in a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies, except in a case in which the basis of the assets distributed is determined under section 334(b)(2); or

(2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D), (F), or (G) of section 368(a)(1),

the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsections (b) and (c). For purposes of the preceding sentence, a reorganization shall be treated as meeting the requirements of subparagraph (D) or (G) of section 368(a)(1) only if the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met.

(b) OPERATING RULES—Except in the case of an acquisition in connection with a reorganization described in subparagraph (F) of section 368(a)(1)—

(1) The taxable year of the distributor or transferor corporation shall end on the date of distribution or transfer.

(2) For purposes of this section, the date of distribution or transfer shall be the day on which the dis-

tribution or transfer is completed; except that, under regulations prescribed by the Secretary, the date when substantially all of the property has been distributed or transferred may be used if the distributor or transferor corporation ceases all operations, other than liquidating activities, after such date.

(3) The corporation acquiring property in a distribution or transfer described in subsection (a) shall not be entitled to carry back a net operating loss or a net capital loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation.

(c) ITEMS OF THE DISTRIBUTOR OR TRANSFEROR CORPORATION—The items referred to in subsection (a) are:

(1) NET OPERATING LOSS CARRYOVERS—The net operating loss carryovers determined under section 172, subject to the following conditions and limitations:

(A) The taxable year of the acquiring corporation to which the net operating loss carryovers of the distributor or transferor corporation are first carried shall be the first taxable year ending after the date of distribution or transfer.

(B) In determining the net operating loss deduction, the portion of such deduction attributable to the net operating loss carryovers of the distributor or transferor corporation to the first taxable year of the acquiring corporation ending after the date of distribution or transfer shall be limited to an amount which bears the same ratio to the taxable income (determined without regard to a net operating loss

deduction) of the acquiring corporation in such taxable year as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year.

(C) For the purpose of determining the amount of the net operating loss carryovers under section 172(b)(2), a net operating loss for a taxable year (hereinafter in this subparagraph referred to as the "loss year") of a distributor or transferor corporation which ends on or before the end of a loss year of the acquiring corporation shall be considered to be a net operating loss for a year prior to such loss year of the acquiring corporation. For the same purpose, the taxable income for a "prior taxable year" (as the term is used in section 172(b)(2)) shall be computed as provided in such section; except that, if the date of distribution or transfer is on a day other than the last day of a taxable year of the acquiring corporation—

(i) such taxable year shall (for the purpose of this subparagraph only) be considered to be 2 taxable years (hereinafter in this subparagraph referred to as the "pre-acquisition part year" and the "post-acquisition part year");

(ii) the pre-acquisition part year shall begin on the same day as such taxable year begins and shall end on the date of distribution or transfer;

(iii) the post-acquisition part year shall begin on the day following the date of distribution or transfer and shall end on the same day as the end of such taxable year;

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(iv) the taxable income for such taxable year (computed with the modifications specified in section 172(b)(2)(A) but without a net operating loss deduction) shall be divided between the pre-acquisition part year and the post-acquisition part year in proportion to the number of days in each;

(v) the net operating loss deduction for the pre-acquisition part year shall be determined as provided in section 172(b)(2)(B), but without regard to a net operating loss year of the distributor or transferor corporation; and

(vi) the net operating loss deduction for the post-acquisition part year shall be determined as provided in section 172(b)(2)(B).

(2) EARNINGS AND PROFITS—In the case of a distribution or transfer described in subsection (a)—

(A) the earnings and profits or deficit in earnings and profits, as the case may be, of the distributor or transferor corporation shall, subject to subparagraph (B), be deemed to have been received or incurred by the acquiring corporation as of the close of the date of the distribution or transfer; and

(B) the deficit in earnings and profits of the distributor, transferor, or acquiring corporation shall be used only to offset earnings and profits accumulated after the date of transfer. For this purpose, the earnings and profits for the taxable year of the acquiring corporation in which the distribution or transfer occurs shall be deemed to have been accumulated after such distribution or transfer in an amount which bears the same ratio to the undistributed earn-

ings and profits of the acquiring corporation for such taxable year (computed without regard to any earnings and profits received from the distributor or transferor corporation, as described in subparagraph (A) of this paragraph) as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year.

(3) CAPITAL LOSS CARRYOVER.—The capital loss carryover determined under section 1212, subject to the following conditions and limitations:

(A) The taxable year of the acquiring corporation to which the capital loss carryover of the distributor or transferor corporation is first carried shall be the first taxable year ending after the date of distribution or transfer.

(B) The capital loss carryover shall be a short-term capital loss in the taxable year determined under subparagraph (A) but shall be limited to an amount which bears the same ratio to the capital gain net income (determined without regard to a short-term capital loss attributable to capital loss carryover), if any, of the acquiring corporation in such taxable year as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year.

(C) For purposes of determining the amount of such capital loss carryover to taxable years following the taxable year determined under subparagraph

(A), the capital gain net income in the taxable year determined under subparagraph (A) shall be considered to be an amount equal to the amount determined under subparagraph (B).

(4) METHOD OF ACCOUNTING.—The acquiring corporation shall use the method of accounting used by the distributor or transferor corporation on the date of distribution or transfer unless different methods were used by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of computing taxable income adopted pursuant to regulations prescribed by the Secretary.

(5) INVENTORIES.—In any case in which inventories are received by the acquiring corporation, such inventories shall be taken by such corporation (in determining its income) on the same basis on which such inventories were taken by the distributor or transferor corporation, unless different methods were used by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of taking inventory adopted pursuant to regulations prescribed by the Secretary.

(6) METHOD OF COMPUTING DEPRECIATION ALLOWANCE.—The acquiring corporation shall be treated as the distributor or transferor corporation for purposes of computing the depreciation allowance under subsec-

tions (b), (j), and (k) of section 167 on property acquired in a distribution or transfer with respect to so much of the basis in the hands of the acquiring corporation as does not exceed the adjusted basis in the hands of the distributor or transferor corporation.

(8) INSTALLMENT METHOD.—If the acquiring corporation acquires installment obligations (the income from which the distributor or transferor corporation reports on the installment basis under section 453 or 453A) the acquiring corporation shall, for purposes of section 453 or 453A, be treated as if it were the distributor or transferor corporation.

(9) AMORTIZATION OF BOND DISCOUNT OR PREMIUM.—If the acquiring corporation assumes liability for bonds of the distributor or transferor corporation issued at a discount or premium, the acquiring corporation shall be treated as the distributor or transferor corporation after the date of distribution or transfer for purposes of determining the amount of amortization allowable or includible with respect to such discount or premium.

(10) TREATMENT OF CERTAIN MINING DEVELOPMENT AND EXPLORATION EXPENSES OF DISTRIBUTOR OR TRANSFEROR CORPORATION.—The acquiring corporation shall be entitled to deduct, as if it were the distributor or transferor corporation, expenses deferred under section 616 (relating to certain development expenditures) if the distributor or transferor corporation has so elected. For the purpose of applying the limitation provided in section 617(h), if, for any taxable year, the distributor or transferor corporation was allowed a deduction under section 617(a), the acquiring corporation shall be deemed to have been allowed such deduction.

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(11) CONTRIBUTIONS TO PENSION PLANS, EMPLOYEES' ANNUITY PLANS, AND STOCK BONUS AND PROFIT-SHARING PLANS.—The acquiring corporation shall be considered to be the distributor or transferor corporation after the date of distribution or transfer for the purpose of determining the amounts deductible under section 404 with respect to pension plans, employees' annuity plans, and stock bonus and profit-sharing plans.

(12) RECOVERY OF BAD DEBTS, PRIOR TAXES, OR DELINQUENCY AMOUNTS.—If the acquiring corporation is entitled to the recovery of bad debts, prior taxes, or delinquency amounts previously deducted or credited by the distributor or transferor corporation, the acquiring corporation shall include in its income such amounts as would have been includible by the distributor or transferor corporation in accordance with section 111 (relating to the recovery of bad debts, prior taxes, and delinquency amounts).

(13) INVOLUNTARY CONVERSIONS UNDER SECTION 1033. —The acquiring corporation shall be treated as the distributor or transferor corporation after the date of distribution or transfer for purposes of applying section 1033.

(14) DIVIDEND CARRYOVER TO PERSONAL HOLDING COMPANY.—The dividend carryover (described in section 564) to taxable years ending after the date of distribution or transfer.

(15) INDEBTEDNESS OF CERTAIN PERSONAL HOLDING COMPANIES.—The acquiring corporation shall be considered to be the distributor or transferor corporation for the purpose of determining the applicability of subsection

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(c) of section 545, relating to deduction with respect to payment of certain indebtedness.

(16) CERTAIN OBLIGATIONS OF DISTRIBUTOR OR TRANSFEROR CORPORATION.—If the acquiring corporation—

(A) assumes an obligation of the distributor or transferor corporation which, after the date of the distribution or transfer, gives rise to a liability, and

(B) such liability, if paid or accrued by the distributor or transferor corporation, would have been deductible in computing its taxable income,

the acquiring corporation shall be entitled to deduct such items when paid or accrued, as the case may be, as if such corporation were the distributor or transferor corporation. A corporation which would have been an acquiring corporation under this section if the date of distribution or transfer had occurred on or after the effective date of the provisions of this subchapter applicable to a liquidation or reorganization, as the case may be, shall be entitled, even though the date of distribution or transfer occurred before such effective date, to apply this paragraph with respect to amounts paid or accrued in taxable years beginning after December 31, 1953, on account of such obligations of the distributor or transferor corporation. This paragraph shall not apply if such obligations are reflected in the amount of stock, securities, or property transferred by the acquiring corporation to the transferor corporation for the property of the transferor corporation.

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(17) DEFICIENCY DIVIDEND OF PERSONAL HOLDING COMPANY.—If the acquiring corporation pays a deficiency divided (as defined in section 547 (d)) with respect to the distributor or transferor corporation, such distributor or transferor corporation shall, with respect to such payments, be entitled to the deficiency dividend deduction provided in section 547.

(18) PERCENTAGE DEPLETION ON EXTRACTION OF ORES OR MINERALS FROM THE WASTE OR RESIDUE OF PRIOR MINING.—The acquiring corporation shall be considered to be the distributor or transferor corporation for the purpose of determining the applicability of section 613(c)(3) (relating to extraction of ores or minerals from the ground).

(19) CHARITABLE CONTRIBUTIONS IN EXCESS OF PRIOR YEARS' LIMITATIONS.—Contributions made in the taxable year ending on the date of distribution or transfer and the 4 prior taxable years by the distributor or transferor corporation in excess of the amount deductible under section 170(b)(2) for such taxable years shall be deductible by the acquiring corporation for its taxable years which begin after the date of distribution or transfer, subject to the limitations imposed in section 170(b)(2). In applying the preceding sentence, each taxable year of the distributor or transferor corporation beginning on or before the date of distribution or transfer shall be treated as a prior taxable year with reference to the acquiring corporation's taxable years beginning after such date.

(22) SUCCESSOR INSURANCE COMPANY.—If the acquiring corporation is an insurance company taxable under

subchapter L, there shall be taken into account (to the extent proper to carry out the purposes of this section and of subchapter L, and under such regulations as may be prescribed by the Secretary) the items required to be taken into account for purposes of subchapter L in respect of the distributor or transferor corporation.

(23) CREDIT UNDER SECTION 38 FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY.—The acquiring corporation shall take into account (to the extent proper to carry out the purposes of this section and section 38, and under such regulations as may be prescribed by the Secretary) the items required to be taken into account for purposes of section 38 in respect of the distributor or transferor corporation.

(24) CREDIT UNDER SECTION 40 FOR WORK INCENTIVE PROGRAM EXPENSES.—The acquiring corporation shall take into account (to the extent proper to carry out the purposes of this section and section 40, and under such regulations as may be prescribed by the Secretary) the items required to be taken into account for purposes of section 40 in respect of the distributor or transferor corporation.

(25) DEFICIENCY DIVIDEND OF REGULATED INVESTMENT COMPANY OF REAL ESTATE INVESTMENT TRUST.—If the acquiring corporation pays a deficiency dividend (as defined in section 860(f)) with respect to the distributor or transferor corporation, such distributor or transferor corporation shall, with respect to such payments, be entitled to the deficiency dividend deduction provided in section 860.

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(26) CREDIT UNDER SECTION 44B FOR EMPLOYMENT OF CERTAIN NEW EMPLOYEES.—The acquiring corporation shall take into account (to the extent proper to carry out the purposes of this section and section 44B, and under such regulations as may be prescribed by the Secretary) the items required to be taken into account for purposes of section 44B in respect of the distributor or transferor corporation.

(27) CREDIT UNDER SECTION 44E FOR ALCOHOL USED AS FUEL.—The acquiring corporation shall take into account (to the extent proper to carry out the purposes of this section and section 44E, and under such regulations as may be prescribed by the Secretary) the items required to be taken into account for purposes of section 44E in respect of the distributor or transferor corporation.

(d) OPERATIONS LOSS CARRYBACKS AND CARRYOVERS OF LIFE INSURANCE COMPANIES.—

For application of this part to operations loss carrybacks and carryovers of life insurance companies, see section 812(f).

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(a) GENERAL RULE.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) EXCEPTIONS.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

(c) PERMISSIBLE METHODS.—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

(d) TAXPAYER ENGAGED IN MORE THAN ONE BUSINESS.—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

(e) REQUIREMENT RESPECTING CHANGE OF ACCOUNTING METHOD.—Except as otherwise expressly provided

in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary.

Treasury Regulation § 1.381(c)(4)-1

(a) *Carryover requirement*—(1) *General rule.* (i) Section 381(c)(4) provides that, in a transaction to which section 381(a) applies, an acquiring corporation shall use the same method of accounting used by the distributor or transferor corporation on the date of distribution or transfer unless different methods of accounting were used on that date by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods of accounting were used, the acquiring corporation shall use the method or combination of methods of accounting adopted pursuant to this section.

(ii) The acquiring corporation shall take into its accounts the dollar balances of those accounts of the distributor or transferor corporation representing items of income or deduction which, because of its method of accounting, were not required or permitted to be included or deducted by the distributor or transferor corporation in computing taxable income for taxable years ending on or before the date of distribution or transfer. The acquiring corporation shall similarly take into its accounts the dollar balances of those accounts of the distributor or transferor corporation which represent reserves in respect of which the distributor or transferor corporation has taken a deduction for taxable years ending on or before the date of distribution or transfer. Items of income and deduction shall have the same character in the hands of the acquiring corporation as they would have had in the hands of the distributor or transferor corporation or corporations if no distribution or transfer had occurred. This section shall have no application to items of income or deduction, or dollar balances, to the

extent they are attributable to assets or liabilities not distributed or transferred, and shall have no application to items the tax treatment of which is specifically provided for in other paragraphs of section 381(c). In the case of an obligation of the distributor or transferor corporation which is assumed by the acquiring corporation and which gives rise to a liability (within the meaning of paragraph (a)(4) of § 1.381(c)(16-1) after the date of distribution or transfer, the deductibility of such an item is determined under this section if it is not deductible under section 381(c)(16) and the regulations thereunder. The amount of the adjustments necessary to reflect a change in accounting method pursuant to this section, the manner in which they are to be taken into account, and the tax attributable thereto shall be determined and computed under section 481 and the regulations thereunder, subject to the rules provided in paragraphs (c) and (d) of this section. Where such change is a change from the accrual to the installment method by a dealer in personal property, section 453(c) and the regulations thereunder apply.

(2) *Rules of application.* For purposes of section 381(c)(4) and this section, the term "method of accounting" shall have the same meaning as that provided under section 446 and the regulations thereunder. This section shall not be construed as preventing the exercise of any election which may be made by the acquiring corporation without consent of the Commissioner, or preventing the application of section 269 or 482, or the regulations thereunder. For provisions defining the date of distribution or transfer, see paragraph (b) of § 1.381(b)-1. See other paragraphs of section 381(c) and the regulations thereunder for other rules regarding the treatment of the carryover of certain items specifically enumerated therein.

Treasury Regulation § 1.381(c)(4)-1

(b) *Conditions for continuation of methods of accounting*—(1) *No differences in methods of accounting.* If all the parties to a section 381(a) transaction used the same method of accounting on the date of distribution or transfer, the acquiring corporation shall continue to use such method of accounting, unless the acquiring corporation has obtained the consent of the Commissioner in accordance with paragraph (e) of § 1.446-1 to use a different method of acounting. This subparagraph may be illustrated by the following examples:

Example (1). X Corporation and Y Corporation use the accrual method as their over-all method of accounting. Both corporations have established a reserve for bad debts under section 166(c). Pursuant to elections made by each corporation, they are amortizing trademark and trade name expenditures over a 60-month period under section 177, expensing intangible drilling and development costs under section 263(c), and accruing real property taxes ratably under section 461(c). It is assumed that there are no other items to which paragraph (a) of this section might apply. Y Corporation acquires all of the assets of X Corporation in a transaction to which section 381(a) applies. On and after the date of distribution or transfer Y Corporation must continue, without further election, to use the same over-all method of accounting and the same accounting treatment of the specified items, unless consent of the Commissioner is obtained in accordance with paragraph (e) of § 1.446-1 to change the methods of accounting. Thus, Y Corporation shall carry over the balance in X Corporation's reserve for bad debts account, shall continue to amortize and deduct over the remaining portion of the 60-month period the unamortized portion of the trademark and trade name expenditures carried over from X Cor-

poration, and shall continue the same treatment of intangible drilling and development costs of real property taxes.

Example (2). M Corporation and N Corporation use the cash receipts and disbursements method of accounting. N Corporation acquires all of the assets and assumes all the obligations of M Corporation in a transaction to which section 381(a) applies. M Corporation, immediately prior to the transaction, is entitled to receive $10,000 for unbilled services performed, and has billed but not received payment for services performed in an amount of $20,000. It has received but not paid invoices amounting to $18,000, and has received services in the amount of $5,000 for which no invoices have been received. Since M Corporation and N Corporation are both on the cash receipts and disbursements method, N Corporation must continue to use that method, unless consent of the Commissioner is obtained in accordance with paragraph (e) of § 1.446-1 to change its method of accounting. Accordingly, N Corporation must include in income when received the unrealized receivables of M Corporation and may deduct the payment of those obligations of M Corporation which would have been deductible by such corporation if paid by it. Thus, N Corporation shall treat as ordinary income the receipt by it of M Corporation's $30,000 of receivables, and may deduct upon payment the amount of M Corporation's $23,000 of payables which would have been deductible by it.

Example (3). S Corporation and T Corporation are both publishers and use the accrual method as their over-all method of accounting. Both corporations have elected under section 455 to defer prepaid subscription income to the taxable years during which the liability to furnish the news-

paper, magazine, or other periodical exists. T Corporation, in a transaction to which section 381(a) applies, acquires all the assets of S Corporation and assumes the liability of such corporation to furnish or deliver the newspaper, magazine, or other periodical. On and after the date of the transfer, T Corporation must continue, without further election, to use the accrual method as its over-all method of accounting and to defer prepaid subscription income under section 455, unless consent of the Commissioner is obtained in accordance with paragraph (e) of § 1.446-1 to change the method of accounting. T Corporation shall carry over the closing balance of S Corporation's prepaid subscription income account. The principles in this example would be equally applicable if both corporations had been deferring prepaid subscription income under a method permitted by subsection (e) of section 455.

(2) *Separate businesses.* If, after the date of distribution or transfer, the trades or businesses of the parties to a transaction described in section 381(a) are operated as separate and distinct trades or businesses within the meaning of paragraph (d) of § 1.446-1, then the method of accounting employed by the parties to the transaction on the date of distribution or transfer with respect to each trade or business shall be used by the acquiring corporation, unless the acquiring corporation has obtained the consent of the Commissioner in accordance with paragraph (e) of § 1.446-1 to use a different method of accounting, or unless the Commissioner prescribes a different method of accounting under paragraph (b) (1) of § 1.446-1. However, if only a single method of accounting may be employed by a taxpayer with respect to a particular item regardless of the number of separate and distinct trades or businesses operated by such taxpayer, but different methods were em-

ployed by the several corporations on the date of distribution or transfer with respect to such item, then the acquiring corporation shall adopt the principal method of accounting determined under paragraph (c) of this section (see subparagraph (2) (iv) thereof) for such item, or the method of accounting determined in accordance with paragraph (d) of this section, whichever is applicable. This subparagraph may be illustrated by the following examples:

Example (1). M Corporation is engaged in a personal service business and uses the cash receipts and disbursements method of accounting. N Corporation is engaged in a retail furniture business and uses the accrual method of accounting. N Corporation acquires the assets of M Corporation in a transaction to which section 381(a) applies. In accordance with paragraph (d) of § 1.446-1, N Corporation operates as a separate and distinct trade or business the personal service business formerly operated by M Corporation. Unless consent of the Commissioner is obtained in accordance with paragraph (e) of § 1.446-1 to change the method of accounting, N Corporation shall continue to use the cash receipts and disbursements method of accounting with respect to the personal service business formerly operated by M Corporation, and shall use the accrual method of accounting with respect to the retail furniture business.

Example (2). Assume the same facts as in example (1), except that M Corporation has elected under section 171 to amortize bond premium with respect to fully taxable bonds. N Corporation has not made the election to amortize bond premium with respect to such bonds owned by it. N Corporation may not continue separate accounting meth-

ods as to amortizable bond premium but must consistently apply only a single method of accounting with respect to such bond premium since the election to amortize bond premium applies to all fully taxable bonds held by the taxpayer. N Corporation shall use the principal method of accounting determined under paragraph (c) of this section for such bond premium, unless it is determined in accordance with paragraph (d) of this section that a different method of accounting is to be used. However, if such principal or different method of accounting is not to amortize bond premium N Corporation is not precluded from making a new election to the extent permitted by section 171.

(3) *Integrated businesses.* (i) If, after the date of distribution or transfer, any of the trades or businesses of the parties to a transaction described in section 381(a) are not operated as separate and distinct trades or businesses within the meaning of paragraph (d) of § 1.446-1, then, to the extent that the same methods of accounting were employed on the date of distribution or transfer by the parties to the transaction with respect to any trades or businesses which are integrated or are required to be integrated in accordance with section 446(d) and the regulations thereunder, the acquiring corporation shall continue to employ such methods of accounting, unless the acquiring corporation has obtained the consent of the Commissioner in accordance with paragraph (e) of § 1.446-1 to use a different method of accounting, or unless the Commissioner prescribes a different method of accounting under paragraph (b) (1) of § 1.446-1.

(ii) If, after the date of distribution or transfer, any of the trades or businesses of the parties to a transaction de-

scribed in section 381(a) are not operated as separate and distinct trades or businesses within the meaning of paragraph (d) of § 1.446-1, then, to the extent that different methods of accounting were employed on the date of distribution or transfer by the parties to the transaction with respect to any trades or businesses which are integrated or required to be integrated in accordance with section 446(d) and the regulations thereunder, this paragraph shall not apply and the acquiring corporation shall adopt the principal method of accounting determined under paragraph (c) of this section, or the method of accounting determined in accordance with paragraph (d) of this section, whichever is applicable.

(iii) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). M Corporation and N Corporation both use the accrual method as an over-all method of accounting. M Corporation has established a reserve for bad debts while N Corporation uses the specific charge-off method with respect to its bad debts. N Corporation acquires all of the assets of M Corporation in a transaction to which section 381(a) applies and integrates the business formerly operated by M Corporation into the business operated by N Corporation before the date of distribution or transfer. N Corporation shall continue to use the accrual method as its over-all method of accounting, unless consent of the Commissioner is obtained in accordance with paragraph (e) of § 1.446-1 to change its method of accounting. N Corporation shall use the principal method of accounting determined under paragraph (c) of this section with respect to bad debts, or the method of accounting determined in ac-

cordance with paragraph (d) of this section, whichever is applicable.

Example (2). X Corporation conducts two separate and distinct trades or businesses, a personal service business with respect to which the cash receipts and disbursements method of accounting is used and a manufacturing business with respect to which the accrual method of accounting is used. Y Corporation conducts a manufacturing business and uses the accrual method of accounting. Y Corporation acquires all of the assets of X Corporation in a transaction to which section 381(a) applies. After the date of distribution or transfer, Y integrates the manufacturing business formerly operated by X Corporation into the manufacturing business operated by it and continues to operate as a separate and distinct trade or business the personal service business formerly operated by X Corporation. Unless consent of the Commissioner is obtained in accordance with paragraph (e) of § 1.446-1 to change the method of accounting, Y Corporation shall continue to use the accrual method of accounting with respect to the integrated manufacturing business and shall continue to use the cash receipts and disbursements method of accounting with respect to the personal service business.

(4) *Rules of application.* In any case where the method of accounting employed on the date of distribution or transfer is continued, it will be unnecessary for the acquiring corporation to renew any election previously made by it or by any distributor or transferor corporation with respect to such method of accounting. Also, the acquiring corporation is bound by any election previously made by it or by any distributor or transferor corporation with respect to such method of accounting which is in effect on the date of

distribution or transfer to the same extent as though the distribution or transfer had not occurred. If, on the date of distribution or transfer, any party to a section 381(a) transaction had no established method of accounting for any item, or came into existence as a result of the transaction, such party shall not be considered to be using a method of accounting for such item or having an over-all method of accounting different from that used by the other parties to the transaction. Where under other sections of the Internal Revenue Code or regulations thereunder a taxpayer is permitted to elect a method of accounting on a project-by-project, job-by-job, or other similar basis (such as the election to charge taxes and carrying charges to capital account under § 1.266-1), that method elected with respect to each project or job shall be deemed to be an established method of accounting only for the project or job for which it is elected. Accordingly, unless two or more of the parties were working on the same project or job and were using different methods of accounting for such project or job before the date of distribution or transfer, the method of accounting previously elected for each project or job must be continued.

(c) *Change of method of accounting without consent of Commissioner*—(1) *General rule.* If the acquiring corporation may not continue to use, under the provisions of paragraph (b) of this section, the method of accounting used by it or the distributor or transferor corporation or corporations on the date of distribution or transfer, the acquiring corporation shall use the principal method of accounting of such corporation (as determined under subparagraph (2) of this paragraph), provided that (i) such method of accounting clearly reflects the income of the acquiring cor-

poration, and (ii) the use of such method is not inconsistent with the provisions of any closing agreement entered into under section 7121 and the regulations thereunder. If the principal method of accounting does not meet these requirements, or if there is no principal method of accounting, see subdivision (i) of paragraph (d)(1) of this section. If the acquiring corporation wishes to use a method of accounting other than the principal method of accounting, see subdivision (ii) of paragraph (d)(1) of this section. Whenever this paragraph applies, the increase or decrease in tax resulting from the change from the method of accounting previously used by any of the corporations involved shall be taken into account by the acquiring corporation. The adjustments necessary to reflect such change and such increase or decrease in tax shall be determined and computed in the same manner as if on the date of distribution or transfer each of the several corporations whose method or methods of accounting are required to be changed in accordance with this section had initiated a change in accounting method. In addition, the acquiring corporation shall take into account the portion of such adjustments which is attributable to pre-1954 Code years to the extent not taken into account by any of the other corporations in accordance with the rules provided in section 481(b)(4) and this paragraph. If the principal method of accounting is adopted under this paragraph, it will be unnecessary for the acquiring corporation to renew any election previously made by it or by any distributor or transferor corporation with respect to such principal method of accounting. Also, in such event, the acquiring corporation is bound by any election previously made by it or by any distributor or transferor corporation with respect to such principal method of accounting which is in effect on the date of dis-

tribution or transfer to the same extent as though the distribution or transfer had not occurred.

(2) *Principal method of accounting.* (i) The determination of the principal method of accounting shall be made with respect to each integrated trade or business operated by the acquiring corporation immediately after the date of distribution or transfer, except with respect to items for which only a single method of accounting may be used by any one taxpayer. See subdivision (iv) of this subparagraph. Such determination for an integrated trade or business shall be made by reference to the methods of accounting used immediately preceding the date of distribution or transfer by each of the component trades or businesses which now constitute the integrated trade or business of the acquiring corporation. The method of accounting for items other than those for which special methods of accounting are provided under chapter 1 of the Code and the regulations thereunder (see § 1.446-1(c)(1)(iii)) shall be governed by the principal over-all method determined for such trade or business under subdivision (ii) of this subparagraph. The method of accounting for items for which special methods of accounting are provided under chapter 1 of the Code and the regulations thereunder shall be determined under subdivision (iii) of this subparagraph.

(ii) The principal over-all method of accounting of an integrated trade or business is determined by making a comparison of—

(*a*) The total of the adjusted bases of the assets (determined under section 1011 and the regulations thereunder) immediately preceding the date of distribution or transfer, and

(*b*) The gross receipts for a representative period (ordinarily the most recent period of 12 consecutive calendar months ending on or prior to the date of distribution or transfer)

of the component trades or businesses which are integrated or are required to be integrated. If more than one component trade or business used the same over-all method, then such total assets and gross receipts of each of the component trades or businesses shall be aggregated and compared with the aggregate of such total assets and gross receipts of other component trades or businesses which used a different over-all method. If this comparison shows that the one or more component trades or businesses (using a common over-all method of accounting) having the greatest total of the adjusted bases of assets also has the greatest amount of gross receipts, then the over-all method of accounting of such one or more component trades or businesses shall be the principal over-all method of accounting. If this comparison shows that the one or more component trades or businesses (using a common over-all method of accounting) having the greatest total of the adjusted bases of assets does not also have the greatest amount of gross receipts, then there is no principal over-all method of accounting, and the acquiring corporation shall request the Commissioner to determine the appropriate over-all method of accounting for such integrated trade or business in accordance with paragraph (d) of this section.

(iii) The principal method of accounting for an item for which a special method or methods of accounting are provided under chapter 1 of the Code and the regulations thereunder is determined by comparing the amounts of such item and related accounts for the component trades or busi-

nesses in accordance with the principles of subdivision (ii) of this subparagraph. Thus, for example, in the case of bad debts, trades or businesses which are components of the integrated trade or business and which had been using the reserve method of accounting will be compared with the other component trades or businesses which had been using the specific charge-off method of accounting. In such a case, the following factors would ordinarily be used in determining the principal method of accounting for bad debts: (*a*) sales on account for the most recent period of 12 consecutive calendar months ending on or prior to the date of distribution or transfer, (*b*) accounts receivable immediately before the date of distribution or transfer, and (*c*) the amount of debts which became worthless within the meaning of section 166(a) and the regulations thereunder during the most recent period of 12 consecutive calendar months ending on or prior to the date of distribution or transfer. If this comparison shows that the one or more component trades or businesses using the same method of accounting with respect to bad debts have the greater amounts of such sales, accounts receivable, and bad debts, then the method of accounting with respect to bad debts for such one or more component trades or businesses shall be the principal method of accounting. If such comparison shows that the one or more component trades or businesses using the same method of accounting with respect to bad debts do not have the greater amounts of all of such items, then there is no principal method of accounting with respect to bad debts, and the acquiring corporation shall request the Commissioner to determine the appropriate method of accounting for bad debts for such integrated trade or business in accordance with paragraph (d) of this section.

(iv) If a single method of accounting must be employed by a taxpayer with respect to a particular item regardless of the number of separate and distinct trades or businesses operated by the taxpayer, the principal method of accounting for such item shall be determined by comparing the aggregate amount of the item and related accounts for all the parties to the transaction using a common method, with the aggregate amount of the item and related accounts for those parties to the transaction which use a different common method. The method of accounting of the party having the greatest aggregate amount of such item and related accounts shall be the principal method of accounting for such item.

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). M Corporation, which commenced business in 1955, uses the cash receipts and disbursements method of accounting, while N Corporation uses the accrual method. On June 30, 1961, N Corporation acquires all of the assets of M Corporation in a transaction to which section 381(a) applies. N Corporation then integrates its own business with that of M Corporation. Immediately prior to the transfer the total of the adjusted bases of the assets of N Corporation was greater than that of M Corporation, and for the 12-month period ending on June 30, 1961, the gross receipts of N Corporation were greater than those of M Corporation. Under such circumstances, the accrual method of accounting is the principal over-all method of accounting and N Corporation shall use such method for the integrated business, provided it clearly reflects income, unless consent of the Commissioner is obtained in accordance with paragraph (d) of this section to use a different

method of accounting. Except as to items for which N Corporation had no established method of accounting and items for which a special method of accounting is provided under chapter 1 of the Code and the regulations thereunder, all adjustments necessary to place the accounts of M Corporation on the accrual method shall be made in accordance with section 481. Any increase or decrease in tax resulting from such adjustments shall be taken into account by N Corporation. Such adjustments and such increase or decrease in tax shall be determined and computed in the same manner as if M Corporation had initiated a change in method of accounting on June 30, 1961.

Example (2). Assume the same facts as in example (1) except that the gross receipts of M Corporation were greater than those of N Corporation for the 12-month period ending on June 30, 1961. N Corporation must, under such circumstances, request the Commissioner to determine the appropriate over-all method of accounting, in accordance with the provisions of paragraph (d) of this section. The necessary adjustments to be made by the corporation whose method of accounting is changed shall be made in accordance with section 481 to place the integrated business on the method so adopted. Any increase or decrease in tax resulting from such adjustments shall be taken into account by N Corporation. Such adjustments and such increase or decrease in tax shall be determined and computed in the same manner as if the corporation whose method is changed had initiated a change in method of accounting on June 30, 1961.

Example (3). Assume the same facts as in example (1). Assume further that M Corporation's deduction for wages and salaries for the 12 calendar months ending on June 30,

1961, is larger than N Corporation's deduction for wages and salaries for such period. Since wages and salaries is not an item for which a special method of accounting is provided under chapter 1 of the Code or the regulations thereunder, the necessary adjustments shall be made in accordance with section 481 to place the wages and salary account of M Corporation on the accrual method of accounting, provided such accrual method clearly reflects income, unless consent of the Commissioner is obtained in accordance with paragraph (d) of this section to use a different method of accounting. Any increase or decrease in tax resulting from such adjustments shall be taken into account by N Corporation. Such adjustments and such increase or decrease in tax shall be determined and computed in the same manner as if M Corporation had initiated a change in method of accounting on June 30, 1961.

Example (4). Assume the same facts as in example (1). Assume further that M Corporation used the specific charge-off method with respect to bad debts, and that N Corporation has established a reserve for bad debts. M Corporation's sales on account and bad debts for the 12 calendar months ending June 30, 1961, were larger than those of N Corporation. Also M Corporation's accounts receivable immediately prior to June 30, 1961, were larger than those of N Corporation. Since the method of accounting for bad debts is a special method of accounting under section 166, M Corporation's method of accounting for bad debts is the principal method of accounting for such item. Assuming such method clearly reflects income, appropriate adjustments shall be made in accordance with section 481 to the accounts of N Corporation to place N Corporation on the specific charge-off method with respect to all of its bad

debts, as if N Corporation had initiated a change in method of accounting on June 30, 1961, and N Corporation shall include the amount of its reserve for bad debts in gross income, unless consent of the Commissioner is obtained in accordance with paragraph (d) of this section to use a different method of accounting.

Example (5). Assume the same facts as in example (1) except that M Corporation commenced business in 1945. In addition, assume that N Corporation is a calendar-year taxpayer and that of the total amount of the adjustments required by section 481 to place the accounts of M Corporation on the accrual method $40,000 is attributable to pre-1954 Code years as described in section 481(b)(4) and the regulations thereunder. Assume further that M Corporation does not elect, under section 481(b)(6), to take the $40,000 portion of the adjustments into account in the manner described in section 481(b)(1) or (2). In computing the increase in tax of M Corporation attributable to the $40,000 portion of the adjustment for the fiscal year ended June 30, 1961, only one-tenth, or $4,000, will be taken into account. The resulting increase in tax shall be taken into account by N Corporation. The remaining nine-tenths of the $40,000 portion of the adjustments, or $36,000, shall be taken into account by N Corporation in the amount of $4,000 in each of the calendar years 1962 through 1970.

(d) *Change of method of accounting with consent of Commissioner*—(1) *General rule.* (i) If the acquiring corporation may not continue to use, under paragraph (b), the method of accounting used by it or the distributor or transferor corporation or corporations on the date of distribution or transfer, and may not under paragraph (c) use the principal method of accounting, or, if there is no principal

method of accounting, then the Commissioner shall determine the appropriate method or combination of methods of accounting to be used.

(ii) If an acquiring corporation wishes to use a method or combination of methods of accounting other than the principal method of accounting which is required to be used by paragraph (c) of this section, it shall apply to the Commissioner for permission to use such other method or combination of methods of accounting. Permission to use such other method or combination of methods of accounting will not be granted unless the acquiring corporation and the Commissioner agree to the terms, conditions, and adjustments under which the change to such method or combination of methods will be effected.

(iii) The increase or decrease in tax resulting from the change from the method of accounting previously used by any of the corporations involved shall be taken into account by the acquiring corporation. The adjustments necessary to reflect such change and such increase or decrease in tax shall be determined and computed in the same manner as if, on the date of distribution or transfer, each of the several corporations that were not using the method or combination of methods of accounting adopted pursuant to subdivision (i) or (ii) of this subparagraph had initiated a change in accounting method.

(2) *Time and manner of making application.* Applications under subparagraph (1) of this paragraph for permission to use a method of accounting or requests for determination of the method of accounting to be used shall be filed with the Commissioner of Internal Revenue, Attention: T:R, Washington, D.C. 20224, not later than 90 days

after the date of distribution or transfer, except that in cases where the date of distribution or transfer occurs before August 5, 1964, such applications or requests shall be filed not later than November 3, 1964. The application shall be accompanied by a copy of the statement described in paragraph (b)(3) of § 1.381(b)-1, and by a statement specifying the nature of the transaction which causes section 381 to apply; the difference in accounting methods used by the corporations concerned; the method or methods of accounting proposed to be used by the acquiring corporation; and the various amounts, if any, of items of income or deduction which will be duplicated or omitted in the computation of taxable income under such proposed method or methods. The Commissioner may also require such other information as may be necessary in order to determine the appropriate method or combination of methods of accounting to be used by the acquiring corporation.

(e) *Special rules applicable to distributions or transfers before August 5, 1964*—(1) *Statute of limitations bars assessment or refund.* If the date of distribution or transfer was before August 5, 1964, and if the assessment of any deficiency or the refund or credit of any overpayment for the taxable year of the acquiring corporation which includes the date of distribution or transfer or any subsequent taxable year is prevented by the operation of any law or rule of law, then this section does not authorize the Commissioner or the acquiring corporation to change any method or methods of accounting in any taxable year of the acquiring corporation. However, the Commissioner or the acquiring corporation may change such method or methods of accounting under the provisions of section 446 and the regulations thereunder or, where applicable, any section of

the Internal Revenue Code (other than section 381(c)(4)), or the regulations thereunder, in accordance with which such changes may be made without the consent of the Commissioner.

(2) *Statute of limitations does not bar assessment and refund.* Except as provided in subparagraph (1) of this paragraph—

(i) If the date of distribution or transfer was before August 5, 1964, and the acquiring corporation has, for the taxable year which includes the date of distribution or transfer, (*a*) adopted or continued a method of accounting consistent with the rules of this section, (*b*) been granted permission by the Commissioner in accordance with paragraph (e) of § 1.446-1 to use a method or combination of methods of accounting, or (*c*) adopted a method of accounting that under other sections of the Internal Revenue Code, or regulations thereunder, may be adopted without the consent of the Commissioner, then the method or methods of accounting adopted or continued in the manner described in (*a*), (*b*), and (*c*) shall not be changed, by reason of the rules contained in this section, by the Commissioner or the acquiring corporation for any taxable year ending after the date of distribution or transfer. However, the Commissioner or the acquiring corporation may change such methods of accounting for any such taxable year under the provisions of, and to the extent permitted by, section 446 and the regulations thereunder or, where applicable, any section of the Internal Revenue Code (other than section 381(c)(4)), or regulations thereunder, in accordance with which such change may be made without the consent of the Commissioner.

Treasury Regulation § 1.381(c)(4)-1

(ii) If the date of distribution or transfer was before August 5, 1964, and the acquiring corporation has, for the taxable year which includes the date of distribution or transfer, adopted or continued a method or methods of accounting other than in the manner described in (*a*), (*b*), and (*c*) of subdivision (i) of this subparagraph, then the acquiring corporation may—

(*a*) Continue to use the method or methods of accounting so adopted or continued if such method or methods clearly reflect income and if proper adjustments were made to reflect the adoption of such method or methods, or

(*b*) Adopt the method or methods of accounting prescribed by this section. Such method or methods of accounting shall be adopted by filing an amended return (which includes the proper adjustments required by this section) for the taxable year of the acquiring corporation which includes the date of distribution or transfer, and by filing amended returns for all subsequent taxable years of the acquiring corporation for which returns have previously been filed. Such amended return or returns shall be accompanied by a copy of the statement described in paragraph (b)(3) of § 1.381(b)-1, and by a statement specifying the nature of the transaction which causes section 381 to apply; the difference in accounting methods used by the corporations concerned; the method or methods of accounting originally adopted by the acquiring corporation; the method or methods of accounting adopted on the amended return or returns; and the computation of the amount of the adjustments and the resulting increase or decrease in tax. [Reg. § 1.381(c)(4)-1.]

Revenue Procedure 71-21, 1971—2 C.B. 549

SECTION 1. PURPOSE

The purpose of this Revenue Procedure is to implement an administrative decision, made by the Commissioner in the exercise of his discretion under section 446 of the Internal Revenue Code of 1954, to allow accrual method taxpayers in certain specified and limited circumstances to defer the inclusion in gross income for Federal income tax purposes of payments received (or amounts due and payable) in one taxable year for services to be performed by the end of the next succeeding taxable year. Amounts due and payable are, for purposes of this Revenue Procedure, treated as payments received.

SEC. 2. BACKGROUND

In general, tax accounting requires that payments received for services to be performed in the future must be included in gross income in the taxable year of receipt. However, this treatment varies from financial accounting conventions consistently used by many accrual method taxpayers in the treatment of payments received in one taxable year for services to be performed by them in the next succeeding taxable year. The purpose of this Revenue Procedure is to reconcile the tax and financial accounting treatment of such payments in a large proportion of these cases without permitting extended deferral in the time of including such payments in gross income for Federal income tax purposes. Such reconciliation will facilitate reporting and verification of such items from the standpoint of both the taxpayers affected and the Internal Revenue Service.

Revenue Procedure 71-21, 1971—2 C.B. 549

SEC. 3. PERMISSIBLE METHODS

.01 An accrual method taxpayer who receives a payment for services to be performed by him in the future and who includes such payment in gross income in the year of receipt is using a proper method of accounting.

.02 An accrual method taxpayer who, pursuant to an agreement (written or otherwise), receives a payment in one taxable year for services, where all of the services under such agreement are required by the agreement as it exists at the end of the taxable year of receipt to be performed by him before the end of the next succeeding taxable year, may include such payment in gross income as earned through the performance of the services, subject to the limitations provided in sections 3.07, 3.08, and 3.11. However, if the inclusion in gross income of payments received is properly deferred under the preceding sentence and for any reason a portion of such services is not performed by the end of the next succeeding taxable year, the amount allocable to the services not so performed must be included in gross income in such next succeeding year, regardless of when (if ever) such services are performed.

.03 Except as provided in sections 3.04 and 3.05, a payment received by an accrual method taxpayer pursuant to an agreement for the performance by him of services must be included in his gross income in the taxable year of receipt if under the terms of the agreement as it exists at the end of such year:

(a) Any portion of the services is to be performed by him after the end of the taxable year immediately succeeding the year of receipt; or

(b) Any portion of the services is to be performed by him at an unspecified future date which may be after the end of the taxable year immediately succeeding the year of receipt.

.04 A payment received for bus or streetcar tokens or transportation tickets with open dates by an accrual method taxpayer in the business of furnishing such transportation may be included in his gross income in accordance with generally accepted industry accounting practices, provided that such payment is included in gross income no later than the taxable year subsequent to the year of receipt.

.05 A payment for a mailer, certificate, or other evidence of a prepaid obligation to process photographic film, prints or other photographic materials, received by an accrual method taxpayer engaged in the photographic processing business, may be included in his gross income in the taxable year in which the required processing operations are performed, provided such payment is included in his gross income no later than the taxable year subsequent to the taxable year of receipt.

.06 In any case in which an advance payment is received pursuant to an agreement which requires the taxpayer to perform contingent services, the amount of an advance payment which is earned in a taxable year through the performance of such services may be determined (a) on a statistical basis if adequate data are available to the taxpayer; (b) on a straightline ratable basis over the time period of the agreement if it is not unreasonable to anticipate at the end of the taxable year of receipt that a substantially ratable portion of the services will be performed in the next succeeding taxable year; or (c) by the use of any other

basis that in the opinion of the Commissioner, results in a clear reflection of income.

.07 Where an agreement requires that a taxpayer perform contingent services (including for this purpose the replacement of parts or materials where the obligation to replace is incidental to an agreement providing for the performance of personal services) with respect to property which is sold, leased, built, installed, or constructed by such taxpayer (or a related person as defined in section 3.10), advance payments received with respect to such agreement may be included in gross income under the method prescribed in section 3.02 only if in the normal course of his business the taxpayer offers to sell, lease, build, install, or construct the property without such a contingent service agreement.

.08 This Revenue Procedure has no application to amounts received under guaranty or warranty contracts or to prepaid rent or prepaid interest. However, for purposes of this Revenue Procedure and section 1.61-8(b) of the Income Tax Regulations (requiring "advance rentals" to be included in income in the year of receipt), the term "rent" does not include payments for the use or occupancy of rooms or other space where significant services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist homes, motor courts, or motels. See section 1.1372-4(b)(5)(vi) of the regulations.

.09 For purposes of this Revenue Procedure, the term "agreement" includes other agreements, written or otherwise, between the taxpayer (or a related person as defined

in section 3.10) and the person for whose benefit the performance under the first agreement is to be rendered if such other agreements provide for rendition of substantially similar performance over a period of time that is substantially consecutive to that of the first agreement.

.10 For purposes of sections 3.07, 3.09, and 5.01, a person is related to the taxpayer if the taxpayer and such other person are owned or controlled directly or indirectly by the same interests within the meaning of section 482 of the Code and section 1.482-1(a) of the regulations.

.11 The amount of any advance payment includible as gross receipts in gross income in the taxable year of receipt by a taxpayer under the foregoing rules shall be no less than the amount of such payment included as gross receipts in gross income for purposes of his books and records and all reports (including consolidated financial statements) to shareholders, partners, other proprietors or beneficiaries and for credit purposes.

.12 The above rules may be illustrated in part as follows:

(1) On November 1, 1970, *A*, a calendar year accrual method taxpayer in the business of giving dancing lessons, receives a payment for a one-year contract commencing on that date which provides for 48 individual, one-hour lessons. Eight lessons are provided in 1970. Under the method prescribed in section 3.02, *A* must include 1/6 of the payment in income for 1970, and 5/6 of such payment in 1971, regardless of whether *A* is for any reason unable to give all the lessons under the contract by the end of 1971.

(2) Assume the same facts as in Example 1 except that the payment is received for a two-year contract commenc-

ing on November 1, 1970, under which 96 lessons are provided. The taxpayer must include the entire payment in his gross income in 1970 since a portion of the services may be performed in 1972.

(3) On June 1, 1970, *B*, a calendar year accrual method taxpayer who is a landscape architect, receives a payment for services which, under the terms of the agreement, must be completed by December, 1971. On December 31, 1970, *B* estimates that ¾ of the work under the agreement has been completed. Under the method prescribed in section 3.02, *B* must include ¾ of the payment in 1970. The remaining ¼ of such payment must be included in 1971, regardless of whether *B* is for any reason unable to complete the job in 1971.

(4) In 1970, *C*, a calendar year accrual method taxpayer in the television repair business, receives payments for one-year contracts under which *C* agrees to repair (or, incidental to providing such repair service to replace) certain parts in the customer's television set if such parts fail to function properly. The television sets to be serviced under *C*'s contracts were not sold, leased, built, installed, or constructed by *C* or by a person related to *C* within the meaning of section 3.10. Therefore, section 3.07 does not apply, and *C* may adopt the method prescribed in section 3.02. Under such method *C* must include such payments in income over the period earned in accordance with one of the bases prescribed in section 3.06, provided that any portion of the payments not included in income in 1970 must be included in income in 1971.

(5) In 1971, *D*, a calendar year accrual method taxpayer in the business of manufacturing, selling and servicing

television sets, receives payments for one-year contingent service contracts with respect to television sets sold by *D* in 1971. *D* offers television sets for sale without contingent service contracts. Under these circumstances, the requirement of section 3.07 is satisfied, and *D* may adopt the method prescribed in section 3.02. Under such method *D* must include such payments in income over the period earned in accordance with one of the bases prescribed in section 3.06, provided that any portion of the payments not included in income in 1971 must be included in income in 1972.

.13 If a taxpayer has adopted the method prescribed in section 3.02, and if in a taxable year the taxpayer dies, ceases to exist in a transaction other than one to which section 381(a) of the Code applies, or his liability to perform the service otherwise ends, then all payments not included in his gross income in a preceding taxable year must be included in his gross income for such taxable year.

.14 The deferral of the inclusion in gross income of amounts in accordance with the foregoing principles will be treated as an acceptable method of accounting under section 446 of the Code as long as the method is consistently used by the taxpayer.

SEC. 4. BOOKS AND RECORDS

Taxpayers who defer the inclusion in gross income of amounts in accordance with the foregoing principles must maintain adequate books and records so that the amount deferred on the income tax return for any year can be verified from such books and records.

SEC. 5. PROCEDURE

.01 Any change by a taxpayer from his present method of including amounts in gross income to the method prescribed in section 3.02 of this Revenue Procedure is a change in method of accounting to which section 446 and section 481 of the Code apply. In addition, the adoption of the method prescribed in section 3.02 for payments received by a taxpayer will be treated in the same manner as a change in method of accounting subject to the consent requirements of section 446(e) of the Code if the payments are for services of a type which were performed by a related person as defined in section 3.10 (or a predecessor thereof) within any of the five taxable years of such person (or predecessor) preceding the taxable year of the adoption.

.02 Taxpayers desiring to change to the method of accounting prescribed in section 3.02 of this Revenue Procedure may request permission to do so by filing Form 3115 (Application for Change in Accounting Method) with the Commissioner of Internal Revenue, Washington, D.C. 20224, in accordance with section 1.446-1(e)(3) of the regulations and Revenue Procedure 70-27, I.R.B. 1970-48, 18.

SEC. 6. EFFECT ON OTHER DOCUMENTS

This Revenue Procedure supersedes Revenue Procedure 70-21, C.B. 1970-2, 501. For the effect of this Revenue Procedure on Revenue Ruling 60-85, C.B. 1960-1, 181; Revenue Ruling 65-141, C.B. 1965-1, 210; Revenue Ruling 68-44, C.B. 1968-1, 191; and Revenue Ruling 70-445, C.B. 1970-2, 101; see Revenue Ruling 71-299, page 51, this Bulletin.

SEC. 7. INQUIRIES

Inquiries concerning the application of this Revenue Procedure should refer to its number and be addressed to Assistant Commissioner (Technical), Attention: T:I:C, Washington, D.C. 20224.

Revenue Ruling 71-299, 1971—2 C.B. 218

Revenue Ruling 60-85, C.B. 1960-1, 181, as it relates to the time for inclusion in income of prepaid income from contracts to furnish services, Revenue Ruling 65-141, C.B. 1965-1, 210, relating to the proper time of inclusion in income of advance payments for room and board received by a college dormitory corporation, and Revenue Ruling 68-44, C.B. 1968-1, 191, as it relates to the time for inclusion in income of amounts due under the "Cropland Adjustment Program" by a taxpayer employing the accrual method of accounting, are modified to the extent inconsistent with Section 3 of Revenue Procedure 71-21, page 549, this Bulletin, relating to the permissible methods of treating advance payments for services to be performed in the future by taxpayers using the accrual method of accounting.

Revenue Ruling 70-445, C.B. 1970-2, 101, which modified the above Revenue Rulings, is superseded.

Opposition

Office - Supreme Court, U.S.
FILED
MAY 28 1982
ALEXANDER L. STEVAS,
CLERK

No. 81-1604

In the Supreme Court of the United States

OCTOBER TERM, 1981

RCA CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the Commissioner of Internal Revenue abused his discretion in requiring petitioner to report in the year of receipt income received in advance for services to be performed upon demand in subsequent years.

2. Whether, in the absence of the Commissioner's consent to change its method of accounting, petitioner was required to continue to use the cash method of accounting employed by its former subsidiary for reporting income received in advance for services to be performed upon demand in subsequent years.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 3a-23a) is reported at 664 F. 2d 881. The opinion of the district court (Pet. App. 28a-65a) is reported at 499 F. Supp. 507.

JURISDICTION

The judgment of the court of appeals (Pet. App. 24a) was entered on November 13, 1981, and the court of appeals denied a timely petition for rehearing and suggestion for rehearing en banc on December 30, 1981 (Pet. App. 1a). The petition for a writ of certiorari was filed on March 30, 1982. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES, REGULATIONS AND OTHER AUTHORITIES INVOLVED

Sections 446 and 381(c)(4) of the Internal Revenue Code of 1954 (26 U.S.C. (& Supp. III)), Section 1.381(c)(4)-1 of

the Treasury Regulations on Income Tax (26 C.F.R.), Rev. Pro. 71-21, 1971-2 Cum. Bull. 549, and Rev. Rul. 71-299, 1971-2 Cum. Bull. 218, are set forth at Pet. App. 66a-111a.

STATEMENT

Since 1946, petitioner has conducted a business, either directly or through its wholly-owned subsidiary, RCA Service Company (RCAS), of servicing television sets and other consumer products that it sold. In the typical service arrangement, purchasers would contract, at the time of purchase, to receive service and repair of the product for a stated period in exchange for prepayment of a single lump sum. Under these arrangements, petitioner would make service available to the purchaser upon demand at any time during the contract term, which might range from three to twenty-four months. Until 1958, RCAS sold and provided this service. On December 31, 1957, however, RCAS was merged into petitioner in a transaction that qualified as a tax-free liquidation of subsidiary to which Sections 332(a) and 334(b)(1) of the Internal Revenue Code of 1954 (26 U.S.C.) were applicable. Thereafter, petitioner continued the service business of RCAS through a division (Pet. App. 4a-5a; Stip. para. 14).

RCAS and, later, petitioner entered their service contract revenues on their books in accordance with an accrual method of accounting. For each group of service contracts of a given duration entered into during a given month, petitioner credited to current income an amount that represented the actual cost of selling and processing the contract, plus a profit. Petitioner credited to a deferred income account the remaining portion of the revenues derived from each group of contracts, *i.e.*, the portion to be earned through future performance of services. Each month thereafter, the portion of the deferred income that was estimated to be earned during the month through actual

performance was transferred from deferred income to current income (Pet. App. 5a).

For the most part, the estimates of the rates of performance for particular classes of contracts were based on past experience in the business. The estimates took into account such factors as seasonal repair patterns, variations in average daily workloads and the number of working days in each month. Although these forecasts were not perfect and may have rested to some extent on untested assumptions, they matched service contract revenues and related expenses with reasonable accuracy (Pet. App. 5a-6a).

Although RCAS has accounted for service contract revenues on an accrual basis in keeping its books, it employed a cash method of accounting for service contract income on its tax returns. For tax purposes, RCAS charged service expenses off against its deffered-income account only when services were performed. On its tax returns, it added to its gross income for each year the amount by which its deferred-income account exceeded the prior year's closing balance; if the amount of the ~~deferred~~-income had decreased, RCAS subtracted the amount of the decrease from gross income. It adopted this cash method in 1948 after the Commissioner had rejected an accrual method as not clearly reflecting income (Pet. App. 6a).

After the liquidation of RCAS, petitioner continued to employ RCAS's accrual method, based upon reasonably accurate forecasts of monthly variations in the demand for service, in its book accounting for prepaid service contract income. For tax purposes, however, petitioner discontinued RCAS's practice of reporting such income on a cash method, and, instead, reported the prepaid service contract income on the same accrual basis that it used in keeping its books. Thus, petitioner included in current income only those service contract revenues that it estimated it had

earned during the taxable year by actual performance (Pet. App. 6a).

By virtue of the deferral of prepaid service—contract income occasioned by this change to an accrual method, and as a result of certain correlative adjustments, petitioner reduced its 1958 and 1959 taxable income by $8,898,916.51 and $2,555,004.68, respectively. These accounting changes and adjustments reduced petitioner's 1958 and 1959 income taxes by $4,627,436.59 and $1,328,602.66, respectively. Petitioner did not—in either 1958 or 1959—seek the Commissioner's permission, pursuant to Section 446(e) of the Internal Revenue Code, to adopt its accrual method of tax accounting for service-contract income (Pet. App. 6a-7a; Stip. para. 46).

Upon audit, the Internal Revenue Service required petitioner to report the revenues it received under the service contracts in 1958 and 1959 upon receipt, rather than on a deferred basis. Petitioner paid the additional taxes, filed administrative claims for refund and, ultimately, commenced this suit for refund in the United States District Court for the Southern District of New York (Pet. App. 7a-8a). The district court ruled in favor of petitioner (Pet. App. 26a-27a). The district court concluded that petitioner was entitled to use a deferred method of accounting based on reliable statistical projections in computing its income for tax purposes as long as that method clearly reflected income. Based on its finding that petitioner's method achieved its objective of matching prepaid service income with related expenses, the district court ruled that the Commissioner had abused his discretion in rejecting petitioner's accrual method reporting prepaid service income (Pet. App. 53a-55a).

The district court also ruled that petitioner was not required to obtain the consent of the Commissioner under Section 446(e) prior to changing to accrual reporting of its

prepaid service income. The district court ruled that, pursuant to Section 1.381(c)(4)-1(e) of the Treasury Regulations on Income Tax (26 C.F.R.), petitioner was entitled, upon the liquidation of RCAS, to adopt an accrual method of accounting for prepaid service income without securing the Commissioner's consent (Pet. App. 60a-65a).

The court of appeals reversed. It ruled that petitioner's deferral of prepaid service income was contrary to the decisions of this Court in *Automobile Club* v. *Commissioner*, 353 U.S. 180 (1957); *American Automobile Association* v. *United States*, 367 U.S. 687 (1961); and *Schlude* v. *Commissioner*, 372 U.S. 128 (1963). It further held that the Commissioner did not abuse his discretion in rejecting petitioner's method of accounting because, when a taxpayer receives income in the form of prepayments for services to be performed upon demand, it is impossible for the taxpayer to predict with certainty the amount of net income that it ultimately will earn from the contract (Pet. App. 17a-18a).

The court of appeals also ruled that under Section 446(e) of the Code, petitioner was not entitled to adopt an accrual method for prepaid service income without the consent of the Commissioner. As it saw the matter, petitioner could not rely upon Section 1.381(c)(4)-1(e) of the Regulations because Section 381(c)(4) of the Code permits a change of accounting method, upon a merger or liquidation, only when different methods of accounting were in use by the parties to the acquisition. Because petitioner did not have prepaid service income prior to the merger, it did not report any such income under a method different from RCAS's. Petitioner therefore could not rely upon Section 1.381(c)(4)-1(e) of the Regulations.

ARGUMENT

1. The court of appeals correctly held that the Commissioner properly exercised his discretion under Section

446(b) in requiring petitioner to report prepaid service income upon receipt. The services at issue were to be performed upon demand. This Court has held three times that a taxpayer that receives advance payments for services to be rendered upon demand in subsequent years must report the payments in full in the year of receipt. *Automobile Club* v. *Commissioner*, 353 U.S. 180, 189-190 (1957); *American Automobile Association* v. *United States*, 367 U.S. 687, 690-694 (1961); and *Schlude* v. *Commissioner*, 372 U.S. 128, 135-136 (1963). As the Court pointed out in *American Automobile Association*, business accounting that defers income beyond the period of receipt to the period when it is estimated services will be rendered may be "in accord with generally accepted commercial accounting principles and practices," but "for income tax purposes," it so clearly reflect[] income as to be binding on the Treasury" (367 U.S. at 693). The Court further ruled that the Commissioner may reject any deferral of prepaid income that is not authorized by statute. *American Automobile Association, supra*, 367 U.S. at 694-698; *Schlude, supra*, 372 U.S. at 134-135. See Sections 455, 456 and 458 of the Code (26 U.S.C. (& Supp. III)).

To be sure, petitioner's method of matching revenues with expenses was based upon experience and was reasonably accurate. In *American Automobile Association*, however, the taxpayer's deferred method of reporting prepaid receipts was likewise reasonably accurate and consistent with its experience, but the Court nevertheless found it inadequate for tax purposes. As the Court stated, "we consider similarly unsatisfactory, from an income tax standpoint, allocation of monthly dues to gross monthly income to the extent of actual service expenditures for the same month computed on a group or pool basis" (367 U.S. at 693).

More recently, in *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979), the Court similarly rejected the adequacy of estimates for tax reporting purposes. There, the Court reaffirmed the authority of its many decisions, including the *Automobile Club, American Automobile Association* and *Schlude* trilogy, that have sustained the Commissioner's "wide discretion" and "broad powers" in determining whether methods of accounting clearly reflect income (439 U.S. at 532). In view of the "diversity, even contrariety, of objectives" (*id.* at 542-543) between financial accounting and tax accounting, the Court reaffirmed the rule that for tax purposes income may not be deferred for the purpose of matching revenues and expenses, stating as follows (439 U.S. at 543; footnote omitted):

> Conversely, where the tax law requires that income be recognized currently under "claim of right," "ability to pay," and "control" rationale, accounting principles may defer accrual until a later year so that revenues and expenses may be better matched. * * * Financial accounting, in short, is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty. This is as it should be.

See, also *American Automobile Association, supra*, 367 U.S. at 692-693.

Contrary to petitioner's argument (Pet. 15-18), the decision below does not conflict with any other appellate precedent regarding advance payments for services because those cases did not involve services to be performed upon demand. Whether or not those decisions are correct, they do not present the "vice" found in the trilogy of cases involving services on demand. Thus, in *Artnell Co.* v. *Commissioner*, 400 F. 2d 981, 984 (7th Cir. 1968), the court found that the "deferred income was allocable to games which were to be played on a fixed schedule." Similarly, in

Boise Cascade Corp. v. *United States*, 530 F. 2d 1367, 1377-1378 (Ct. Cl.), certiorari denied on another issue, 429 U.S. 867 (1976), the court found that the taxpayer's "contractual obligations were fixed and definite. In no sense was [taxpayer's] performance of services dependent solely upon the demand or request of its clientele" (footnote omitted). And *Morgan Guaranty Trust Co.* v. *United States*, 585 F. 2d 988, 997 (Ct. Cl. 1978), did not involve prepayments for services but, rather, prepaid interest, and "the date upon which the prepaid interest was subsequently earned could be computed to the day."

In short, this case, like the trilogy of this Court's accounting method decisions, involves services to be performed upon demand, rather than obligations as to which the time for performance was fixed. To be sure, the decisions upon which petitioner relies also rejected the government's alternative argument that the Commissioner may reject any deferral of prepaid income that is not specificallly authorized by statute. *Artnell Co., supra*, 400 F. 2d at 984-985; *Boise Cascade Corp., supra*, 530 F. 2d at 1378; *Morgan Guaranty Trust Co., supra*, 585 F. 2d at 997. To the extent those decisions hold otherwise, we believe that those decisions are erroneous. The Court expressly held in *Schlude* and *American Automobile Association* that the Commissioner is free to reject any accounting system deferring prepaid income that is not specifically authorized by statute. *Schlude, supra*, 372 U.S. at 134-135; *American Automobile Association, supra*, 367 U.S. at 694-698. But in view of its disposition of this case on the ground that the government's revenues may not be subjected "to the uncertainties inherent in prognostications about the rate at which customers would demand services in the future" (Pet. App. 19a), the court of appeals found it unnecessary to address that issue (Pet. App. 20a n.10). Moreover, given the district court's erroneous application of the law, the court of

appeals was not bound by the district court's finding that petitioner's method clearly reflected income (see Pet. App. 20a). Accordingly, the decision below does not conflict with either *Artnell Co.* or *Boise Cascasde.*[1]

3. Because the merger of RCAS into petitioner was a tax-free liquidation to which Section 381(a)(1) of the Code applied, petitioner succeeded to certain tax attributes of RCAS. At issue here is the question whether petitioner was required to continue the cash method of accounting used by RCAS for reporting prepaid service income. In this respect, Section 381(c)(4) (Pet. App. 71a) provides, in pertinent part, that the acquiring corporation "shall" use the method of accounting used by the acquired corporation unless at the time of the acquisition the acquiring corporation and the acquired corporation used different methods of accounting. If different methods were used, the acquiring corporation shall use a method adopted pursuant to regulations promulgated by the Secretary.

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[1]The Commissioner, exercising his discretion under Section 446, now permits limited deferrals of prepaid service income. Rev. Proc. 71-21, 1971-2 Cum. Bull. 549; Rev. Rul. 71-299, 1971-2 Cum. Bull. 218. In general, the Commissioner now permits deferred reporting of advance payments if the services are to be performed by the end of the taxable year succeeding the year of receipt. The purpose of the Commissioner's ruling position is "to reconcile the tax and financial accounting treatment of such payments in a large proportion of these cases without permitting extended deferral in the time of including such payments in gross income for Federal income tax purposes." Rev. Proc. 71-21, 1971-2 Cum. Bull. 549. Cf. Section 1.451-5 (26 C.F.R.) (permitting substantial deferral of advance payments on the sale of certain types of goods).

Contrary to petitioner's argument (Pet. 18 n.14), Revenue Procedure 71-21 and Revenue Ruling 71-299 have no application to this case. As the court of appeals correctly observed (Pet. App. 23a), petitioner may not claim the benefits of those announcements for the years in suit because it was required to obtain the Commissioner's consent before employing the accounting methods that those announcements permit, but did not do so. See Rev. Proc. 71-21, *supra*, § 5, 1971-2 Cum. Bull. at 550-551; Section 446(e)(3) of the Code; Section 1.451-5. (26 C.F.R.)

The court of appeals correctly held that petitioner was required to continue RCA's cash method of reporting prepaid service income. Section 381(c)(4) plainly provides that the acquiring corporation may adopt a new method of accounting only if the parties to the acquisition already were using different methods. It is equally plain that petitioner and RCAS were not using different methods of accounting for prepaid service income because, prior to the liquidation, petitioner had no such income to report.

Treasury Regulations, Section 1.381(c)(4)-1(e) (26 C.F.R.), upon which petitioner relies (Pet. 15), is not to the contrary. It sets forth special rules implementing Section 381(c)(4) with respect to the ten-year period after enactment of the statute and before promulgation of the regulations. Nothing in the special rules, however, purports to ignore the requirement of Section 381(c)(4) that, absent the use of different accounting methods by the parties to the acquisition, the acquiring corporation must continue the accounting method of the acquired corporation. Rather, the Regulation, of which the special rules are a part, is explicit that a new method of accounting may be adopted under it only if "different methods of accounting were used" on the date of the acquisition. See Section 1.381(c)(4)-1(a)(1)(i). Furthermore, the authorities upon which petitioner relies (Pet. 17) do not even suggest that an acquiring corporation may adopt a new method of accounting when the parties to the acquisition used the same method. See Section 1.381(c)(4)-1(a)(1)(ii), (a)(2), (b)(1), (b)(3)(i) and (b)(4); Rev. Rul. 70-83, 1970-1 Cum. Bull. 85; and Rev. Rul. 70-241, 1970-1 Cum. Bull. 84. Thus, while the Regulation treats situations where the parties used the same accounting method, it respects in every instance the statutory requirement that,

absent different methods of accounting, an acquiring corporation must continue the accounting method of the acquired company.[2]

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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[2]Finally, the decision below does not conflict, as petitioner asserts (Pet. 16), with *VCA Corp.*, 215 Ct. Cl. 939 (1977), adopting the result in 77-2 U.S. Tax Cases para. 9554. That decision did not involve any question of the proper accounting method to be adopted by an acquiring corporation. The question there was whether an acquiring corporation was entitled to deduct a liability that arose, after an acquisition, out of an obligation of the acquired corporation. The Court of Claims Special Trial Judge held that the liability in question was deductible under Section 1.381(c)(4)-1(a)(1)(ii), see 77-2 U.S. Tax Cases para. 9554, at 87,956-87,857, and, without adopting the opinion of the Trial Judge, the court agreed with that conclusion (215 Ct. Cl. at 940).

Petitioner's Reply Brief

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REPLY BRIEF FOR THE PETITIONER

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REPLY BRIEF FOR THE PETITIONER

1. In its Petition for a Writ of Certiorari, RCA Corporation ("RCA") stated that one of the reasons for granting the writ of certiorari in this case was the conflict between the decision of the Second Circuit Court of Appeals below and that of other courts that have considered the issues raised in this case.* Specifically, RCA noted:

> "In holding that a trial court cannot for itself make the threshold determination of whether a method of accounting clearly reflects income—'[t]he issue before the district court was not whether RCA's accounting method adequately reflected income' (20a)—the court of appeals placed itself squarely in conflict with a num-

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* Citation to the appendix is "—a". In response to Rule 28.1 of the Rules of this Court, Petitioner states that it has no parent companies and no subsidiaries other than wholly-owned subsidiaries.

> ber of appellate decisions. These decisions recognize not only that a court must determine whether a method of accounting clearly reflects income in order to ascertain whether the Commissioner abused his discretion, but also that the Commissioner has no discretion to compel a taxpayer to adopt a different method of accounting if the method employed by that taxpayer clearly reflects income. Indeed, one line of such cases arises, just as this case does, in the context of accounting for unearned receipts." (Petition at 6-7)

The Brief in Opposition to RCA's Petition for a Writ of Certiorari acknowledges the existence of a conflict of authorities. The IRS admits that the decisions cited by RCA in fact rejected the IRS's argument—accepted below —"that the Commissioner may reject any deferral of prepaid income that is not specifically authorized by statute," but the IRS asserts that the conflict should be overlooked because the IRS "believe[s] that those decisions are erroneous" (Brief in Opposition at 8). Having acknowledged an ever-increasing conflict in this important area of the law, the IRS has implicitly conceded that the writ of certiorari should be granted.

2. Contrary to the assertions of the IRS (Brief in Opposition at 6-8), no decision of this Court dictates the result of the Second Circuit Court of Appeals in the instant litigation. No case decided by this Court supports the Second Circuit's ruling that a trial court may not consider whether a taxpayer's method of accounting clearly reflects income in determining whether the Commissioner abused his discretion. Both *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 189 (1957), and *American Automobile Ass'n* v. *United States*, 367 U.S. 687 (1961), found the taxpayer's accounting method to be "purely artificial and [bearing]

no relation to the services which petitioner [might] in fact be called upon to render for the member." In *Schlude* v. *Commissioner*, 372 U.S. 128, 136 (1963), this Court also relied for its decision on a finding that the taxpayers' method did not clearly reflect income and suggested that a statistical accounting method might have provided a basis for ruling in favor of the taxpayer. 372 U.S. at 136 & n.9. None of these cases undermines RCA's position in the instant litigation, since each of these decisions approved a determination by a trial court that a method of accounting did not clearly reflect income.*

Nor does this Court's decision in *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979), support the IRS's claim of virtually absolute authority by the IRS to reject even those methods of accounting that clearly reflect income. Rather, this case recognized that the IRS's discretion to determine whether a particular method of accounting clearly reflects income "is not unbridled and may not be arbitrary." *Id.* at 533. This Court found in *Thor* that the IRS did not abuse its discretion because the taxpayer's method of accounting "was plainly inconsistent with the governing [Treasury] Regulations which the taxpayer, on its part, has not challenged." *Id.* at 533 (footnote omitted).

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* The IRS concedes that "[t]o be sure, [RCA's] method of matching revenues with expenses was *based* upon experience and was reasonably accurate" (Brief in Opposition at 6, emphasis added), but equates RCA's method with the taxpayer's method in *AAA* which also was supposed to have been reasonably accurate, but was nevertheless rejected. In so arguing, the IRS artfully attempts to divert attention from the fundamental difference in the systems—RCA's method was "based" on its experience and designed specifically to match its income with the expenses incurred in earning it as required by the accrual method of accounting; AAA's method took receipts into income arbitrarily and whatever consistency it had with actual experience was totally fortuitous and merely offered as a *post hoc* rationalization of the system. It was this arbitrariness—totally lacking from RCA's system—which led to the rejection of AAA's accounting method.

In RCA's case, where no regulation or ruling forbids use of RCA's method of accounting (indeed, where the IRS has adopted a revenue procedure and revenue ruling authorizing a deferral method of accounting for unearned receipts that is virtually identical to that used by RCA), the decision in *Thor* does not foreclose the use of that method and certainly does not forbid a court from considering, as the trial court below did, whether a method of accounting clearly reflects income.

3. The IRS argues that Judge Lasker's factual findings to the effect that RCA's method of accounting for unearned receipts matched revenues with expenses and clearly reflected income could be disregarded because the Court of Appeals concluded that the District Court erred as a matter of law. (Brief in Opposition at 8-9) This proposition is untenable when the purported legal error goes solely to whether or not the Court had the authority to make the finding in the first instance, and not to the finding itself. Below the Court of Appeals did not question the findings or the means by which they were reached, but held that the District Court lacked the authority "to determine whether in its own opinion RCA's method of accounting for prepaid service contract income 'clearly reflect[ed] income'" (13a). This finding is in direct conflict, *inter alia,* with the decision of the Court of Appeals for the Seventh Circuit in *Artnell Co.* v. *Commissioner,* 400 F.2d 981 (7th Cir. 1968), which reversed the Tax Court in a case involving unearned receipts and remanded with instructions to determine whether the "method of accounting did clearly reflect [the taxpayer's] income . . . ." *Id.* at 985. If *Artnell* was correct, the Court of Appeals was indeed bound by the District Court's factual findings.

4. The IRS's contention that "Revenue Procedure 71-21 and Revenue Ruling 71-299 have no application to this case"

(Brief in Opposition at 9, n.1) is also in error. First, Revenue Ruling 71-299 does not incorporate the procedural provisions of Section 5 of Revenue Procedure 71-21, but only the substantive provisions, and, therefore, Revenue Ruling 71-299 is retroactive pursuant to Section 7805(b) of the Internal Revenue Code of 1954, as amended (the "Code"), and Treas. Reg. § 601.601(d)(2)(v)(c) without regard to the procedural consent provisions of Section 5. Moreover, the IRS fails to respond either to the erroneous conclusion by the Second Circuit on this point, in disregard of the parties' stipulation of facts and the relevant documentary evidence, that RCA had not sought the consent of the IRS to adopt the method of accounting permitted by Revenue Procedure 71-21 or to RCA's contention that such consent is unnecessary under the cited statute and Treasury Regulation.

5. The IRS, in its arguments on the applicability of the regulations under Section 381(c)(4) of the Code to RCA, abandons the rationale of the Court of Appeals below. It does not—because it cannot—support the Court's conclusion that the regulations under Section 381(c)(4) do not apply to RCA.

Although the IRS concedes that the Section 381(c)(4) regulations do apply to RCA, it asserts that the transitional rules contain an implicit requirement that the parties to the transaction use different methods of accounting on the date of the acquisition. Since nothing in the language of Treas. Reg. § 1.381(c)(4)-1(e)(1) indicates that such an implicit requirement exists, the IRS is forced to find support for its argument elsewhere, *viz.*, an entirely different portion of the Section 381(c)(4) regulations, Treas. Reg. § 1.381(c)(4)-1(a)(1)(i) (Brief in Opposition at 10). This argument cannot be reconciled with the clear and precise language of Treas. Reg. § 1.381(c)(4)-1(e)(1) which provides simply

that, (1) if the date of the liquidation was before August 5, 1964 and (2) if the year of liquidation is closed under the statute of limitations, then "this section does not authorize the Commissioner or the acquiring corporation to change any method or methods of accounting in any taxable year of the acquiring corporation" (99a). A more lucid formulation of the standard to be applied is not possible. The special rules in Treas. Reg. § 1.381(c)(4)-1(e)(1) provide that other provisions of the regulations under Section 381(c)(4), including those provisions cited by the IRS, may not be relied upon in requiring a taxpayer to change the method of accounting it chose in the year of liquidation. Thus, even were the IRS correct that Treas. Reg. § 1.381 (c)(4)-1(e)(1) sets up a requirement that different methods of accounting be used by the corporations in question, the application of that requirement here is barred by the express terms of Treas. Reg. § 1.381(c)(4)-1(e)(1).

Nobody questions that RCA met both tests expressly set forth in the special rules. Nor can there be any disagreement that under the explicit language of Treas. Reg. § 1.381 (c)(4)-1(e)(1) itself, RCA's adoption of accounting method is permissible regardless of whether RCA and RCAS used the same or different accounting methods. Neither the patently erroneous rationale of the Court of Appeals nor the equally unsound argument of the IRS here provides any basis for departing from this plain and clear language. The district court was correct in ruling that the position advanced by RCA was "the only plausible reading" of Treas. Reg. § 1.381(c)(4)-1(e)(1) (62a).

CONCLUSION

The IRS requests that this Court continue the confusion in this area of law by declining to review the circuit court's decision. In doing so, the IRS relies on mischaracterization of applicable law and on arguments that are totally different than those employed by the Court of Appeals below. There could not be a more eloquent testimonial to the need for Supreme Court review in this area than the arguments set forth in the Brief in Opposition. If the IRS is unwilling to defend the novel theories espoused by the Second Circuit Court of Appeals then, we submit, it is time for Supreme Court review. That is particularly the case here in that, should the opinion below be allowed to stand unchallenged, it will be forever cited for the proposition that the IRS has the discretion to reject a taxpayer's method of accounting even though that method of accounting clearly reflects the taxpayer's income, a proposition which can only lead to great mischief.

Respectfully submitted,

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